Basler Bankenstudien

Herausgegeben von Prof. Dr. Dr. h.c. Henner Schierenbeck

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The Corporate Centre in a Financial Conglomerate:

Governance under Fundamental Industry Changes

Verlag Paul Haupt

Bern · Stuttgart · Wien

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The financial support of the *Dissertationenfonds* of the University of Basel is gratefully acknowledged

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Dedicated to the memory of

Hendelena de Groot-Goldsmit

ACCOMPANYING NOTE

The dynamics in the financial services industry is reaching new heights. Consolidation, changing regulation, technological innovation, globalisation, customer sophistication and lowering of entry barriers are just six examples of factors, which are reshaping the industry. In comparison to manufacturing industries, the financial services industry now is going through times of increasing maturity, leading to increased competition both on revenues and costs. This increased competition leads to a high variety and complexity of questions to be answered by academics, business managers and regulators alike. Not only is the industry changing fundamentally, also new management practices have to be taken into account. The focus on shareholder value, the notion of risk as a central component to that, and now very actual the topic of operational risk management, and corporate governance are just three topics, which are of paramount importance to good corporate management. It is with this background that this study deals with the question of operationalising corporate governance while representing shareholders, who take risk by participating in the share capital of the financial conglomerate. The analysis results in a concept for the corporate centre as *the* operational tool for corporate management in striving for synergies in a financial conglomerate.

In the first part, the author discusses the main trends in the financial services industry: consolidation, blurring industry demarcations and the special case of internet banking, and shows with this the complexity, which characterises today's financial world. This industry complexity has profound influence on questions of strategy and structure. Financial conglomerates try to deal with this industry complexity by strategic reorientation and organisational renewal; the author goes on to discuss financial conglomerate structures in more detail and appraises the underpinning of the various appearances of financial conglomerates. In shaping financial conglomerates, managers find a guide in value-based bank management and, in this study specifically, operational risk management. As the author argues, focus, understanding and measurements on all levels of the organisation are of utmost importance to manage financial conglomerates for risk-aware value creation.

In the second part, the author focuses on the main tool for corporate management in a financial conglomerate: the corporate centre. Its essence, organisational design, and economics are core elements in the analysis for operational corporate governance. Various roles, (de-) centralisation, coordination instruments and added value are presented, leading to an understanding of the corporate centre norm for tackling problem areas, exercising management styles and undertaking activities. The economics of the corporate centre, which the author discusses afterwards, both on the level of the division as well as in managerial terms, lead to comprehensive insights in organisational dynamics and corporate centre value creation.

In the third part, the integrated corporate centre concept for financial conglomerates (ICCC) is presented. Based on the insights and analysis in parts 1 and 2, the normative ICCC-concept encompasses 1) the organisational focus in terms of core and added value roles, functions, departments, and coordination instruments, 2) the value proposition of the corporate centre as manager of a portfolio of businesses and as the ultimate operational risk manager with the appropriate ICCC-management style, and 3) the economic justification for the corporate centre, which includes value creation and measurement, using the presented *ResVal*-method, a detailed cost benchmark, and a way to treat those costs in a meaningful manner. Given that, as the author found, financial conglomerates are moving towards a weak variant of conglomeration, this ICCC-concept can be flexibly applied to financial conglomerates in issues of organisational redesign and in benchmarking corporate centres. The ICCC-concept is then compared with four representative case-studies, studied in the year 2000. The case-studies provide in interesting feedback and identify opportunities for financial conglomerates to improve their operational corporate governance.

In this study, the author took on various perspectives on a highly relevant contemporary issue for financial conglomerates; this resulted in increased insights, which deserve to be taken into account by both academics and practitioners alike active in this exciting part of the economy.

Basel, Summer 2002

Henner Schierenbeck

FOREWORD

With the completion of this study, a long-time wish is fulfilled. Already before graduating from my first degree, I felt the need to add something to what I was studying - not only consuming literature. With the completion of this book, I hope and trust, something has been added which can be of use to academics and practitioners of bank management. The topic of the research touches upon something essential in society. It deals with the operational governance of institutions, which have profound impact on economies: financial conglomerates. In that respect, it is fascinating to be able to contribute to discussions concerning this topic. In this study, challenging as it was by itself, I employed relevant English, German and Dutch literature. To me it proved that valuable insights are there for the taking, when one expands the scope to include literature from other than one's own language. Especially researchers in the English speaking area, I would like to invite to explore the rich German body of knowledge.

It is obvious that a study such as this cannot be accomplished in complete isolation. Therefore, first and foremost, I would like to thank my distinguished *Doktorvater*, Professor Dr. Dr. h.c. Henner Schierenbeck, lecturing at the University of Basel. It was he who enabled me to start this study while I was still working full-time, and who believed in my capability to finish it successfully. I also would like to express my gratitude to Professor Dr. Dick M.N. van Wensveen, former Chairman of the Board of MeesPierson and now lecturing at the Erasmus University Rotterdam and at the University of Amsterdam. He spontaneously and flexibly supported me with concrete in-depth expertise. His suggestions made this study more comprehensive, which is greatly valued. Further at the University of Basel, I would like to thank Assistant-Professor Dr. Claudia Wöhle, who supported me during the research process on various issues I encountered both content and process.

I owe gratitude to UBS, which, as my former employer, was willing to support this study with infrastructure and time. At ABN AMRO, I would like to thank Mr. Tom de Swaan, Chief Financial Officer and Head Corporate Center. At Credit Suisse Group, I would like to thank Mr. Thomas Widmer, Director, Head Group Controlling and Deputy Head Group Planning & Reporting. At Deutsche Bank, I would like to thank Dr. Thomas R. Fischer, former Chief Risk and Operating Officer, and Mr. Joachim Hellermann, Head Corporate Center Coordination. At UBS, I would like to thank my former boss: Dr. Peter Pop, Executive Director, former Head Corporate Center Operations and now at UBS Asset Management, Head Strategic Development, EMEA.

Further, I would like to thank my friends and parents who always showed interest and who were there when I needed to reflect on this lengthy project. Notwithstanding this, I would like to single out a few special individuals: I would like to thank Mr. Robert-Frank Hofland who critically read through the thesis and came up with very useful comments. Also, Dr. Markus Voegelin, who was there when I needed deliberation and who provided very insightful comments, deserves a heartfelt *Danke schön*. The same goes to Professor Dr. Torsten Arnsfeld of the University of Applied Sciences in Osnabrück, with whom I had very fruitful discussions. My thanks also go to Dr. Stefan Paul for his very helpful remarks, and to Ms. Smita Dutta who made English out of my English. Last but not least, I would like to thank my own banker, my wife: Mrs. Yifan Qin. She provided me with support of the invaluable kind, both moral and content, during the most important phases of the project and encouraged me continuously.

Singapore, in May 2002

OUTLINE

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GENERAL INTRODUCTION

Trends in the financial services industry

The financial services sector has a pivotal role in modern societies. In more advanced service economies, such as the United States, the financial sector employs more people than the manufacturing of apparel, automobiles, computers, pharmaceuticals, and steel combined; U. S. financial services firms employ 5.4 million people. Financial services account for almost 5 percent of the U. S. gross domestic product, about 5.5 percent of the German, 3.5 percent of the Italian, 6.5 percent of the Singaporean and 9 percent of the Swiss (Harker & Zenios, 1998, p.1). Financial services firms also currently account for seventy-two of the top three hundred or 24 percent quoted European companies and their importance in market capitalization is even greater (Volberda et al, 2001b, p.210). Impressive as these statistics may be, they belie the greater indirect role that this industry has in the economy. At the time of this study, the financial services industry shows an enormous dynamism (see also Taylor, 1999). We witness the following trends simultaneously:

- Mergers and acquisitions, where related companies create multinational financial services conglomerates
- Entrance of traditional non-financial services firms into financial services
- Entrance of internet companies offering financial services often at lower cost
- Deregulation and liberalisation, enabling new activities but also prescribing new regulation
- Disintermediation: firms raising capital by issuing bonds rather than borrowing from banks
- Innovation in financial products enabling further customer sophistication
- Increasing volumes on capital markets simultaneously as these markets become more international.

These trends above interact with each other and sometimes one trend sparks another trend. The changing environment is the catalyst for major restructuring and consolidation of the industry. To a larger extent, consolidation is based on a belief that gains can accrue through economies of scale and scope, increased market power and reduced earnings volatility (Pilloff & Santomero, 1997, p.4). Studies have found large inefficiencies, on the order of 20 percent or more of total financial services industry costs, and about half of the industry's potential profits (Berger & Mester, 1997, p.1), which, theoretically, can be gained by consolidation. Opportunities are still available in exploiting niche markets or in market dominance (Schierenbeck, 1999, p.23).

At the same time the investors' and management's focuses are shifting. More than anything else, creation of shareholder value becomes paramount. This importance stems from the notion that shareholders, e.g. private investors and pension funds, run the ultimate entrepreneurial residual risk of a listed corporation. It also implies that all of the company's investment decisions have to benefit shareholders in a way that compensates them for their risk. Shareholder value creation can also function as a yardstick for corporate performance. Especially the manner in which shareholder value creation is measured receives special interest. Accounting profit only is no longer the only indication of firms' profitability or a characteristic of measuring investment performance as 1) accounting rules allow for ambiguity, 2) as contingent investment requirements are excluded, and 3) as the time value of money is ignored. Measurement of shareholder value creation deals with calculating a return on invested capital, based on adjusted accounting rules, over the cost of capital of the firm. This latter component reflects risk, emphasising risk to be a central component of the shareholder value concept. Due to further pressures on the profits in the financial services industry, it is to be expected that the focus on shareholder value creation becomes more significant and leads to further restructuring in the financial services industry. The forming of the EMU transformed Europe in a still not-perfect, level playing field, which can be compared with the United States; striking is that the EU still has a considerable backlog (Van Wensveen, 2000, p.2). EU financial conglomerates have a lower profitability their US peers, due to a decreased interest rate spread and increased credit risk provisions, and are less cost-effective, a.o. due to more branches.

The role and characteristics of financial service companies

Vander Vennet (1998, 2000) classifies financial services firms with the following characteristics, delineating banks by their revealed degree of functional diversification and universality, based on observed organisational and financial characteristics. He distinguishes three major areas of financial services: 1) traditional banking, 2) insurance, and 3) intermediation services. He defines financial conglomerates as financial services firms which conduct at least two of the three activities and universal banks as diversified banking institutions[1] that also hold equity stakes, totaling more than 1% of the assets of the financial services firms, in non-financial companies. Although different financial intermediaries are growing in importance, banks are still pre-eminent in the financial system. First, they are vital to economic activity, because they reallocate money from savers, who have a temporary surplus of it, to borrowers, who can make

[1] Vander Vennet (1998, p.7) also notes that he classifies a bank as diversified when the ratio of non-interest income to total revenues exceeds 15%, for financial conglomerates that number would lie at 20% and for universal banks this number must be greater than 5%; this is a useful indicator as fee-income earned on non-traditional banking activities such as insurance and securities trading is registered as non-interest income in the annual statements.

better use of it; banks profit from the difference in borrowing- and lending rates, also known as the *margin* or the *spread*. Second, banks are at the heart of the clearing system. By collaborating to clear payments, they help individuals and firms fulfil transactions. Banks also borrow money from other banks in what is called the interbank market. As the spread is being driven down by better information and increasing sophistication of capital markets, banks have tried to boost their profits with fee generating businesses, such as selling mutual funds and advice on mergers, public offerings et cetera.

Most of a bank's liabilities have shorter maturities than its assets. There is, therefore, a mismatch between the liabilities and assets. This mismatch can lead to problems if depositors become concerned enough about the quality of a bank's lending book that they demand their deposits. Although some overdrafts or credit lines can be called in, longer-term loans are much less liquid. This *maturity transformation* can cause a bank to fail (*liquidity risk*). A more common danger is *credit risk*, the possibility that borrowers will be unable to repay loans. This risk tends to mount in periods of prosperity, when banks relax their lending criteria, only to become apparent when recession strikes. A third threat to banks is *interest-rate risk*, the possibility that a bank will have to pay more interest on short-term funding of the mismatch than it can charge for loans. Because banks provide credit and operate the payments system, their failures can have a more damaging effect on the economy than the collapse of other businesses. Hence governments pay particular attention to the regulation of banks. Individual banks have reserve requirements: they must hold a proportion of their deposits at the central bank, where they are safe and immediately accessible. A second cushion against a liquidity crisis is the central bank, acting as a lender of last resort, known as the *safety net*. When solvent bank struggle to raise money, a central bank, can step in and provide finance. Another way in which regulators have tried to support banks is to force them to match a proportion of their risky assets with capital, in the form of equity or retained earnings. The collapse of one bank can spread trouble throughout the financial system as depositors from other, healthy, banks suddenly fear for their money. Regulators then step in because they want to prevent a collapse of the entire system. Governments try to minimise the risk of such failure in several ways. One is to impose harsher regulation on banks than on other industries. Another manner is to try to prevent runs on banks in the first place, e.g. via government deposit insurance designs. It can be argued that these guarantees make bank failures more likely, because they encourage depositors to be indifferent to the riskiness of banks' lending. Moreover, as banks get bigger, they are likely to conclude that they are "too big to fail", a further incentive to take on more risk. To combat this moral hazard, regulators try to be ambiguous about how big is *too* big, and to restrict the amount of insurance they provide. So, internal considerations and external developments have urged executive boards of banks to rethink their positioning, their service offerings and their organisation. For example, European financial conglomerates give high priority to (Van Wensveen, 1997, p.16):

- Extension of investment banking activities globally, by taking over brokers and merchant banks
- Extension of institutional asset management globally
- Build up of consumer banking activities, aimed at certain countries, and higher-income clients
- Selective extension of corporate banking activities directed at certain countries and midsize and larger corporate clients, while maintaining market share at home
- More attention to smaller enterprises and cost reduction.

A competitive advantage can only be achieved when financial services firms re-invent themselves on a continuous basis while interacting with their business environments. This process of re-inventing can take place on many fronts: market segments, competencies and the organisation, enabling a profitable interaction with the business environment. Many organisational initiatives can be taken to increase shareholder value. An umbrella for these initiatives is given in the term *value-based management*, where all activities are aligned toward the goal of value creation. Lowering risk, thereby lowering the required return on equity, and varying financing between debt and equity are two possibilities to create value. Although the literature on financial services firms pays a great amount of attention to classical risks, as described above, focus on *operational risk* is required. Interestingly, this type of risk derives more from management and governance issues than other risks known to financial services firms [1]. From an organisational viewpoint, the pressure to reach a higher level of profitability and efficiency and the lower level of (operational) risk is translated into the redesign of processes and the adaptation to leaner organisational structures. This practice is already known in mature industries, mostly industries characterised by the increasing commodity nature of the products (e.g. steel) or the stage of maturity of the industry (e.g. bulk chemicals). One recent development is that financial conglomerates tend to assume a structure comparable with those in the manufacturing industry, suggesting that the business environment in which financial conglomerates operate is becoming increasingly comparable to more mature industry. Financial conglomerates often report products or client orientated divisions with their own profit responsibilities instead of with a predominantly regional focus, or a mixture thereof. This process of divisionalisation also leads to internal transfers of services in order to service an external client better. One part of this divisionalising process is the creation of

[1] In this respect, the Bank of England report on the demise of Barings Bank revealed some insights on operational risk. First, management teams had the duty to understand fully the businesses they managed. Second, responsibility for each business activity had to be clearly established and communicated. Third, relevant internal controls must be established for all business activities. Fourth, top management and the audit committee must ensure that significant weaknesses are resolved quickly (Crouhy et al, 1998, p.45).

corporate centre, a function, which is not an operating division generating revenue through external clients, but merely a division looking after the common interests of all divisions, the corporate group. This corporate centre over time has taken on the roles of a holding, performing management services to and on behalf of the divisions[1]. One can say that in financial conglomerates, a corporate centre often produces qualitative gains, such as increased brand strength or more efficient processes by standardisation. These gains, difficult to quantify, must be higher than the well measurable costs of the corporate centre.

Introduction of the research

The number one banana skin for banking is poor management[2]

It is not until recently, that financial services have been seen as an industry, such as the manufacturing industry, for which certain industry rules apply. Despite international regulatory harmonisation, the corporate structures of financial services companies still differ across countries, mainly reflecting historical differences (Borio & Filosa, 1994). However, in terms of organisational renewal, of eight large financial services firms investigated in the Netherlands and the United Kingdom, seven firms show similar behaviour. This suggests an industry specific common mindset or shared managerial schema, at least regarding the content of strategic renewal (Volberda et al, 2001b, p.220). This *herd behaviour* may play an important role for renewal processes in the financials services industries[3,4].

What we aim for in this study is to present an integrated concept for the corporate centre in financial conglomerates. This concept deals with questions about the corporate centre, on the nature and the role, design, management, organisation, and economics. This is done in the light of the reasons for existence of financial conglomerates and the fundamental changes in the financial services industry. This attempt for organisational renewal adds to the statement of Volberda et al (2001b, p.219) that more financially aware firms[5], which financial conglomerates certainly are, engage in a greater number of renewal actions. In the financial services industry, this renewal is a necessity in years to come. This study, which bases itself on theory while interacting with practice, can be

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[1] An example of this is when the corporate centre performs the function of communicating with the capital markets on behalf of all divisions, so as to influence the share price of the group.
[2] Marshall (2001, p.76).
[3] This was also found by Flier et al (2000); for an analysis of herd behaviour see DiMaggio & Powell (1983).
[4] This result was unexpected as the samples come from different sectors of the financials services industry under different regulatory regimes with both public and private firms involved.
[5] A firm is called financially aware when management puts emphasis on disclosure of company information in financial terms, thereby trying to align interests of managers and shareholders and decreasing agency costs (see also Cools & Van Praag, 2000).

characterised explorative, culminating in a normative statement. In addition, it attempts to introduce a new element into the discussions on operational corporate governance of financial conglomerates. These insights contribute to the academic literature. Although there is a large body of literature on related topics on the level of the financial service industry or on financial transaction level, there is hardly any literature available, which provides in analyses on the level of the firm. In that respect, this study can reveal new avenues for further research. Managers, who seek to contribute to shareholder value by means of increasing organisational efficiencies[1], could be made more aware of issues without having the natural limitations of the own organisation, or use such research as an independent comparison. This necessity has not been fully acknowledged yet by all, as witnessed by a recent quote from a senior bank manager about his career:

…he was the Head of Corporate Centre – 'please don't use that title'[2].

Regulators may use this research to better understand the issues facing financial conglomerate management so as to provide improved regulation, since governance increasingly becomes an issue. As Volberda et al (2001b, p.210) stated: in this turbulent environment, both researchers and practitioners need theories as to how financial services firms can renew themselves. Figure 1 shows the framework of the study. In part 1, we will start off with a review of the developments in the financial services industry and the effects of these developments on financial conglomerates on a global scale. We will then continue with the question of conglomeration and prototypes of conglomerates. Value-based management, including operational risk management, is the last major topic in part 1. In part 2, the corporate centre will be discussed in more detail. This part will touch upon issues of decentralisation, organisational design and the financial management of a corporate centre. In part 3, we will discuss the synthesis of parts 1 and 2 and we will compare the theoretical findings with four representative case studies in order to see how major financial services firms deal with their corporate centres in relation to the discussed industry trends. With case studies, the external validity is more limited than with surveys under many entities in which, based on statistical analysis, a high degree of validity can be established. However, case studies allow for a deeper understanding of issues involved, as qualitative, non-measurable

[1] An example in case is the Rabobank Group of Utrecht, the Netherlands. As the Rabobank Group, a cooperative financial services firm, grew in size due to acquisitions it came to resemble a large centralised organisation. Organisational units began to complain that the corporate centre became too powerful by imposing its product-driven strategies upon organisational units such as the local banks. In 1999, the Rabobank Group reported that a top priority was the creation of synergy between the organisational units, while at the same time the corporate centre was to be reduced in size by a more decentralised management approach (Volberda et al, 2001a, p.171).

[2] In quotation marks: Mr Luqman Arnold, ex-President and ex-Head of the Corporate Centre of UBS AG and at present Chief Executive of Abbey National Group in an interview with *The Observer* (01.12.2002).

aspects receive more attention than in qualitative analysis. Using four cases is a first step in the process of testing theoretical development and generalising conclusions. Yin (1989) on cases studies: *Case studies, like experiments, are generalisable to theoretical propositions and not to populations or universes. In this sense, the case study, like the experiment, does not represent a 'sample', and the investigator's goal is to expand and generalise theories (analytical generalisation) and not to enumerate frequencies (statistical generalisations). It is of the utmost importance that the case studies encompass important elements and that they are of great societal, scientific or policy value*. The selected cases are the following globally active financial conglomerates: ABN AMRO Bank of Amsterdam, the Netherlands, Credit Suisse Group of Zurich, Switzerland, Deutsche Bank of Frankfurt, Germany, and UBS of Basel and Zurich, Switzerland. The cases are well documented and information from within the companies has been made available. The case studies provide valuable insights on current practice and a first opportunity to review the ICCC-model and complement the theory.

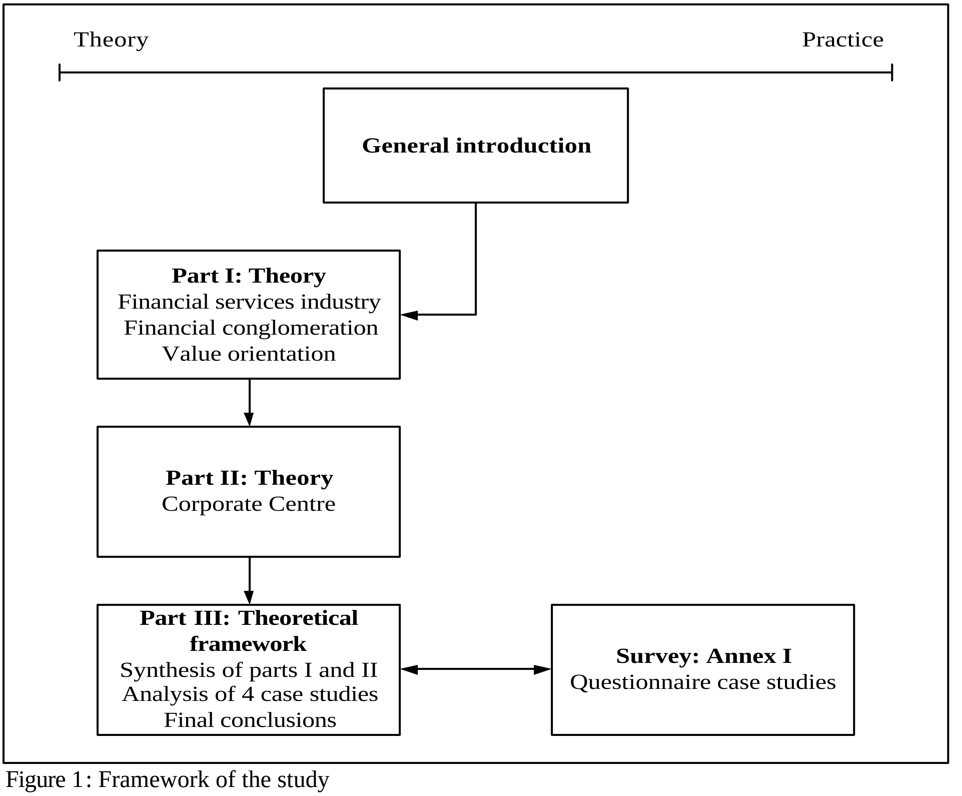

Figure 1: Framework of the study

PART 1: THE FINANCIAL SERVICES INDUSTRY, FINANCIAL CONGLOMERATION AND VALUE ORIENTATION

In this chapter, we will describe the trends in the financial services industry, the financial conglomerate and value-based management. As we will see from the banking literature, many observations have been made on consolidation, regulation, competition, risk management, conglomeration and synergies. All these notes will lead to a detailed understanding of the dynamics and complexity of the financial services industry, how financial conglomerates organise themselves so as to cope with this and which concepts are important for corporate intentions.

A. Transformation of the financial services industry

I. Consolidation

1. Sector view on consolidation

a) Systemic risk

Systemic risk is defined here as the risk that credit, market or liquidity problems of one or more financial market participants create substantial credit, market or liquidity problems for participants elsewhere in the financial system and can jeopardise the whole financial system. The contagion effect can be transferred through the financial system in a number of ways, including failures to settle in payments system, panic runs following revelation of an institution's problems because of a lack of transparency, or falling prices, liquidity problems, or markets failing to clear when large volumes of securities are offered for sale simultaneously. Consolidation may affect systemic risk in part because it changes the risks of individual institutions, particularly the risks of large institutions whose credit, market or liquidity problems may affect many other institutions. If the risk of an individual institution is higher, this raises the probability that the institution will fail or become illiquid before settling some of its payments obligations, exposing other institutions directly to risks as payees, or indirectly through contributing to panic runs or securities markets problems. Consolidation may also affect systemic risk in part because it increases the sizes of the institutions. The systemic consequences of the failures of larger players may be more severe, spreading problems to more counterparties, particularly for institutions that are heavily involved in clearing and settlement functions. To some extent, these systemic problems created by larger institutions may be partially offset if the smaller number of larger institutions facilitates monitoring of risks by government supervisors or counterpart institutions. Some theoretical and empirical evidence suggests that the monitoring of banks by other banks may be an efficient mechanism for controlling systemic risk, and this task may be easier after consolidation (Calomiris & Kahn, 1996). Consolidation may impose costs on the financial system by expanding the financial *safety net*[1]. Consolidation may also improve the efficiency of risk management by economising on the amount of collateral needed to control risks on large-value transfer systems (Humphrey, 1998). Saunders & Walter (1994) argue that, in the US, a move to universal banking would enhance the efficiency of the financial services sector, without increasing the risks to financial system stability.

b) The flow of money

Consolidation can have several effects on the efficiency of the payments system. Mergers and acquisitions reduce the amount of payments processing because payments between consolidating firms become intercompany payments[2]. In addition, many of the remaining interbank payments may be cleared more quickly and efficiently because there are fewer endpoints to which to send payment information or payment instruments. Financial service industry consolidation might also improve efficiency by allowing resources to flow to more efficient payments processors or by allowing financial services firms to find more efficient means to exchange payments. Consolidation of the financial services industry into fewer and larger players may make it easier to agree on payment standards and a common technology with standardised protocols and fixed technical standards to take advantage of network economies[3]. There may be a *market failure* in payments pricing where payers do not bear the full marginal costs of their payments and receive float benefits during the time it takes to collect the funds. Consolidation could result in more rational pricing of payments, agreements to remove much of the float benefits, as occurred in the highly concentrated Canadian and Norwegian financial services industries, as well as speeding the adoption of electronic technologies (Humphrey et al, 1998).

[1] Government guarantees to protect debtholders or shareholders.The safety net may provide additional protection to firms considered "too big to fail", which may be created by consolidation. The safety net may also be extended when mergers and acquisitions combine banking with non-traditional financial services activities such as insurance and securities underwriting. A result may be the enhancement and the growth of the semi-financial services sector at the expense of competing 'pure play' financial services providers to a point that may represent a socially inefficient allocation of resources (of the safety net).

[2] Payments between these institutions or between their customers require no interbank transfer of funds, as the transaction is internal to the consolidated firm.

[3] However, the necessary co-operation may be achieved *without* substantial financial services industry consolidation through the use of the correspondent banking system, outsourcing to service providers, common ownership of facilities, government mandate of standards, or mandatory sharing rules (Solomon, 1999).

c) Influence of the government and regulators

Regulators for financial conglomerates have three objectives of supervision: 1) micro-economic stability, 2) investor protection, and 3) proper behaviour, efficiency and competition. The regulatory choices concerning the functional scope of financial service firms may have implications for the evolution of the structure of the financial services industry globally, since the strategic options for financial services firms in terms of functional diversification depend to a large extent on the regulatory environment in which they operate (Vander Vennet, 2000, p.140). The government plays a direct role in consolidation decisions through restricting the types of mergers and acquisitions permitted and through approval and disapproval decisions for individual mergers or acquisitions. In part, this is to limit the government's liability and to prevent exploitation of the safety net[1]. One way to control the systemic risks and safety net subsidies that may accompany consolidation is through new approaches to the supervision of financial institutions. Recognising that non-traditional activities and new financial instruments may increase the speed at which losses may occur as well as their magnitudes may increase, efforts are underway to revamp the basic approach to supervision.

The recent focus is to shift away from formula-focused capital standards and mandated portfolio structures towards improvements in transparency and the supervision of risk management systems. Supervisors may require that institutions have in place systems to monitor and control their own risk-taking. New capital requirements for market risk are based on banks' internal risk measurement models (Hendricks & Hirtle, 1997), and new approaches to capital requirements for credit risk are under study (Jones & Mingo, 1999). Another possibility is to increase market discipline through mandatory subordinated debt or other requirements (Calomiris, 1997). A related question is that of optimal organisational supervisory structure. The divisional model with a corporate holding would combine functional regulation (banking authorities regulate banking subsidiaries, securities authorities regulate securities subsidiaries etc.) with umbrella sight over the whole financial services firm[2]. The Basel Committee on Banking Supervision sees an opportunity to enhance safety and soundness in the banking system by public disclosure by banks in order to create transparency for market participants (BIS, 1999a, BIS, 1999d). More explicitly, six broad categories of information have been identified; these are financial performance, financial position (including capital, solvency and liquidity), risk management strategies and practices, risk exposures

[1] Regulators prevent mergers and acquisitions when an excessive increase in risk or an excessive increase in market power is expected. Government may also encourage consolidation when this is a solution for troubled financial institutions in times of financial crisis.

[2] This supervisory structure permits functional regulators to focus on a narrow set of activities, maintain a high level of expertise, and possibly avoid imposing strong bank-like restrictions on other activities. The presence of an umbrella supervisor may also facilitate review of the institution as a whole and scrutiny of decision-making, policies, and internal controls at the highest level (Kwast, 1996).

(including credit risk, market risk, liquidity risk, and operational, legal and other risks), accounting policies, and basic business, management and corporate governance information. Striking is that the Basel Committee on Banking Supervision gives special attention to this last topic in a separate paper (BIS, 1999b). In there, it was stated that for banking sound corporate governance practices include: 1) establishing strategic objectives and a set of corporate values that are communicated throughout the organisation, 2) setting and enforcing clear lines of responsibility and accountability, 3) ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence, 4) ensuring of appropriate oversight by senior management, 5) effectively utilising the work conducted by internal and external auditors, in recognition of the important control function they provide, 6) ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment, and 7) conducting corporate governance in a transparent manner. This suggests that the regulator will become more active in the field of operational governance of financial services firms.

2. Geographical view on consolidation

The transfer of securities, goods, and services in international markets creates demands for currency, deposit, loan, and other services by international financial institutions. Thus, the globalisation of markets has likely contributed to (cross-border) mergers and acquisitions and the globalisation of financial services firms [1] (Meyer, 1998). The United States have the largest single financial market, implying that there are relatively many financial institutions. Table 1 summarises the changes in the U.S. banking industry over the period from 1988 to 1997; in this period the decrease of the number of banking organisations was 26.8 percent[2] (Berger et al, 1999, p.64).

	1988	**1989**	**1990**	**1991**	**1992**
# of US banking organisations	9,881	9,620	9,391	9,168	8,873
decrease p.a. (%)		2.6	2.4	2.4	3.2
	1993	**1994**	**1995**	**1996**	**1997**
# of US banking organisations	8,446	8,018	7,686	7,421	7,234
decrease p.a. (%)	4.8	5.1	4.1	3.4	2.5

Table 1: Development of US banking organisations 1988-1997

[1] The causation likely works in the other direction as well.
[2] Note that in 1979, the United States had 12463 banking organisations.

Although these statistics show the situation till 1997, we can safely assume further consolidation[1]. Also in Europe we see major consolidation going on. In Germany, for example, the number of independent banks has decreased by 5.3 percent per annum since 1990 until 1995, which sums up to a decline from 5000 firms in 1990 to 3600 firms at ultimo 1995 (Lang, 1996, p.1). Table 2 shows some examples of Western Europe for 1998.

Company 1	**with company 2**
Banque National de Paris (F)	Paribas (F)
Banca Commerciale Italiana (IT)	Intesa (IT)
MeritaNordbanken (S/F)	Unidanmark (DK)
Swiss Bank Corporation	Union Bank of Switzerland
Royal Bank of Scotland (UK)	National Westminster (UK)
HSBC (UK)	Crédit Commercial de France (F)
Fortis (NL/B)	Generale Bank (B)
BSCH (S)	Banca Serfin (S)
ING (NL)	BBL (B)

Table 2 : Example of bank mergers in Western Europe

Van Wensveen (1997, p.17ff) predicted that after the formation of the EMU, mergers among equals within the EU would be within national boundaries and would be defensive in nature, as:

- Cost savings can only be reached when overlaps in large cost bocks, such as branch networks, can be eliminated. This is mostly only possible nationally
- The differences in culture are bigger in international than in national mergers
- The demand for the combination of banking and insurance products: the very nature of these products, where advantages are determined by national fiscal policy, makes nationally oriented insurance companies more attractive to same nations banks
- Values of European banks are not in parallel and their development over time is also different; one financial institution of a specific country is therefore expensive in relation to another country, which makes it difficult to convince shareholders

[1] An example of a major merger was the combination of Citibank and the Travelers Group into Citigroup in which the prospect of cross selling of consumer finance products was a major driver (Euromoney, 2000, p.30). Special in this case is the fact that Citigroup applied for the status of a bank holding company and anticipated the changes in the regulations as discussed in paragraph 1.B.3. Further examples in 1998 include the mergers, BankAmerica-NationsBank, Banc One-First Chicago and Norwest-Wells Fargo (Moore & Siems, 1998). Noteworthy is that various American (investment) banks have been taken over by financial conglomerates (examples include Bankers Trust, taken over by Deutsche Bank and Donaldson Lufkin & Jenrette taken over by Credit Suisse Group).

- Banks do not want to invade other banks on their turf as they prefer to compete outside of the EU.

At the same time, inroads in Europe have been made by American firms [1]. Also in Japan, restructuring and consolidation is a phenomenon[2]. The Bank of China, one of the big four state banks, announced that it would merge 12 member banks in Hong Kong into one in preparation for a public listing[3].

3. The rationale for industry consolidation

a) Technological progress

Technology is eroding entry barriers and hence financial institutions face pressures from a wider and more diverse range of competitors. Although information technology is important for the internal workings of the financial services firm, client-focused technologies make the difference in market appearance. In this respect we distinguish[4] (Flier et al, 2001, p.187):

- Automated teller machine networks (first introduced in Sweden in 1972)
- Electronic payment methods at the point of sale (EFTPoS), using direct debit cards (first introduced in Sweden in 1986)
- E-purse, a microchip card, which stores electronic money (first introduced in the Netherlands in 1996)
- Remote banking[5] including telephone banking (first introduced in Sweden in 1985), PC banking (first introduced in the United Kingdom in 1985) and internet banking (again first introduced in Sweden in 1995).

These technologies open up new delivery channels, and while those are not necessarily more cost effective for the firm, consumers get to depend on them and demand access. Whereas in the past the branch was the only channel for the distribution of financial services, we see today a variety of channels eroding the branch's dominance. Financial innovation and the power of new technologies have tended to increase the relative

[1] Examples are the take-over of Schroders (UK) by Citigroup and of Flemings (UK) by Chase Manhattan.
[2] In August 1999, Dai-Ichi Kangyo, Fuji and Industrial Bank of Japan announced that they were to merge in 2002 and would create the world largest bank by assets (Euromoney, 1999, p.48). In October 1999, Sumitomo and Sakura announced that they too plan to merge in 2002. The new Japanese institutions will not be legally possible until 2002 because changes are required to both the tax code and to company law. For Japan, this consolidation is revolutionary in nature as the operations of the three banks will be re-organised and run along business lines and will therefore cut across the old banking organisations, the final structure of the bank will be a holding company overseeing three separate units again divided along business lines.
[3] Also, the bank needs to accumulate capital ahead of China's accession into the World Trade Organisation, which is expected to bring an upsurge in foreign competition (Financial Times, 2000, p.17).
[4] For an in-depth review of how information technology has changed banking, we refer to Carrington et al, 1997. Topics include payment systems, credit cards, automated branches, etc.
[5] Managing one's account without physically going to a bank's office.

competitiveness of the capital market vis-à-vis financial services firms, and new delivery technologies have lowered the cost of alternative suppliers of financial services to the extent that they no longer need to develop full branch networks. There is also something of a vicious circle: as capital markets become more efficient, firms have a greater incentive to disclose more information in order to get access to capital market facilities. In turn, this increased supply of information also enables the capital market to function more effectively and act as a greater competitor to banks in their traditional lending business (Llewellyn, 1999, p.32). Given the dependence of the financial services firm on technology and the influence of technology on competition, financial services firms try to realise economies of scale by combining technological capacities and to try and create comparative advantage from the use of technology by trying to gain an information advantage.

b) Evolving customer demands

The emergence of new and diverse financial products creates new challenges for financial institutions that now face a host of product-mix and marketing questions along with new competitors. As a result of changing consumer needs, we have seen an accelerated growth of financial innovation (Consiglio & Zenios, 1997). For example, financial innovation provides savers with greater flexibility in managing their portfolios by enhancing the available instrument choice, and by making existing instruments more accessible[1] (Browne, 1992). In 1980, almost 40 percent of the U.S. consumer financial assets were in bank deposits. By 1996 bank deposits accounted for less than 20 percent of consumers' financial assets with mutual funds and insurance/pension funds absorbing the difference. Financial innovation has enhanced the relative attractiveness of capital markets for many corporate borrowers. Developments in the options and asset pricing theory, securitisation, and the evolution of contingent claims and guarantees, have also led to a deconstruction of the services traditionally provided by financial services firms into their constituent components (Lewellyn, 1999, p.39)[2].

c) Macro-economic factors

Bank-based versus market-based systems: besides competition between firms, we can also distinguish competition between financial systems. Considering the transfer of

[1] Examples of changing consumer preference include remote banking, a whole new range of financial products and one-stop financial shopping. Payment methods have seen a gradual change from cheques and cash towards debit and credit cards and, most recently, to electronic payment devices (Flier et al, 2001, p.193). Whereas the typical bank offers a dozen or two different choices of mutual funds, institutions such as Fidelity Investment or Merrill Lynch each offer over 100 different products.

[2] To take securitisation of bank loansas an example: a bank makes a loan, temporarily holds it on the balance sheet, but subsequently securitises it on the capital market, making it suited for mass trade in secondary markets by standardisation. This way, customers get a more sophisticated offer of products.

money, we see that in some countries financial services firms play a larger role than in others. Where banks take on the larger part of the financing need, we speak of a *bank-based system*. The role of banks though, carries well beyond credit extension to, based on private information, share ownership, share voting and board membership with sometimes far-reaching powers, such as capital allocation, management changes, and restructuring of firms (Walter, 2000, p.74). Where capital markets take over the financing function, we speak of a *market-based system*. Commercial banking relationships with major companies can be very important but they tend to be between *buyer* and *seller*. Corporate control tends to be exercised through the take-over market on the basis of widely available public information, with the function of the financial services firm limited mainly to advising and financing bids. Demirguc-Kunt & Levine (2000, p.15ff) found that in higher income countries, banks do not become larger or smaller relative to the size of domestic capital markets. But looked at from the level of activity, these capital markets tend to become more active and efficient relative to credit activities of domestic banks.

Deregulation: we can distinguish between different categories of regulatory changes (Flier et al, 2001, p.183ff): 1) eliminating restrictions on domestic competition, removal of limitations to the use of competitive tools such as interest rate controls and the loosening of controls on capital flows that limit foreign competition, 2) changing the scale and scope of financial activities, including cross-border establishments and limits on combining banking, insurance and securities activities within a single firm, and 3) improving the external competitive position of financial services firms, including solvency regulations, capital adequacy requirements, and reserve and investment coefficients. In the United States, restrictions on banks' ability to expand geographically were relaxed in the 1980s and 1990s. There has also been deregulation of restrictions on bank powers in the United States. As discussed in paragraph 1.B.3, the activities of investment and commercial banking combined are now allowed in the United States. Europe also has been undergoing deregulation. The European Union Banking directive has allowed banks to operate freely across national boundaries as well as acquire in Europe since 1993.

Excess capacity: Davis & Salo (2000) looked at the presence of excess capacity as a precondition for consolidation. Excess capacity is formed in case of a decline in demand for financial services, technological shocks making existing capacity redundant, a shift of distribution of demand, new competitors, changes in regulation, and firms strategic behaviour[1]. Using profitability measures, Davis & Salo (2000, p.70ff) come to the conclusion that excess capacity in the United States has been decreasing over the last years. The same applies to the European area although there, more excess capacity is

[1] E.g. to build up capacity as a barrier to entry for new competitors, or when increases in demand are expected.

still present. As some firms may be below an efficient scale or have an inefficient product mix, consolidation opens the way for eliminating excess capacity[1].

II. The changing borders of the financial services industry

1. Description of near-banking

Near-banking has not been researched at large, but we increasingly see that companies from different industry backgrounds diversify into financial services, as far as regulation allows[2]. The rise of near-banking tells that the financial services industry is attractive and that firms are of the opinion that the level of competition between financial services firms is not so high they could not be profitable. Also it tells that the skills needed for banking and insurance have disseminated in other industries. This lowers barriers to entry. Also, we see that financial services firms actually diversify outside of the financials services industry[3]. Often that step is part of the strategy to diversify risk, to link services in search of a market niche, to broaden the customer base or to reach a larger share of the client's wallet.

2. Towards a notion of in-house banking

a) Understanding in-house banking

We discussed banking in the general introduction and we saw that the main activities of banking are taking deposits, giving credit facilities, clearing transactions and advising on financial matters. Examples of financial activities done by an in-house bank within an industrial firm include cash management, treasury, borrowing, investing and

[1] Institutions that are troubled because of excess capacity in their industry or markets, their own inefficiency, or underperforming investments are often taken over as an efficient alternative to bankruptcy or other exits.

[2] Examples from different industries include the following:

- Marks and Spencer, the retailer in the United Kingdom, made a significant entry into financial services. By restricting in-store payment to cash, cheque, or the store's own card, the firm has recruited a large number of cardholders. Analysing clients' spending has enabled the firm to target these individuals for loans, saving products, pension and mutual funds through the mail. The firm now recognises that selling financial products forms a larger part of their strategy
- In consulting, we see that management-consulting firms start venture capital operations. Due to the nature of the work management consultants often encounter companies, which with management and capital effort could indeed improve performance. Examples of this trend include Bain & Company. Broader, consulting firms compete with banks in corporate finance type activities
- Near-banking is also a topic in Japan: Sony plans to offer all types of consumer loans, mainly online. Also, Ito-Yokado, best known as the operator of the 7-11 stores, would put cash machines that would double as e-commerce terminals in their stores. Interesting here is that there are discussions in Japan on giving these non-banks banking licenses
- Maybe the best-known example is General Electric, which has a non-bank business unit GE Capital. This unit offers a full range of financial services such as leasing, debt- and equity financing, insurance and credit cards, all targeted at selected industry and consumer groups.

[3] Notably, on a very limited scale some financial services firms in the United Kingdom have entered non-financial businesses such as selling cars (Lloyds TSB), stationary (RBS) and coffee (Abbey National).

portfolio activities. As the level of financial activities of industrial firms increased over the years, because industrial firms were doing financial activities internally in a treasury department, the topic of in-house banking became more actual and increasingly had a more profound effect on the financial services industry. The treasury department became a bank for divisions, replacing in part or in full the business lines to external financial services firms. In his study, Bereuter (1995, p.34ff) deals with the different definitions and this leads to the following synthesis: in-house banking can be defined as a far-reaching separation of the financial management function in order to increase the company's1 value by achieving financial synergies, while being responsible for general financial management issues on the company level, and offering financial services within the company, and/or doing transactions on the capital markets insofar these are necessary for the company without the involvement of financial services firms [2].

b) Responsibilities and activities of an in-house bank

Hommels (1995, p.181) distinguishes between three sets of responsibilities of the in-house bank: 1) consulting: in a decentralised organisation, decisions are made in the divisions, often based on recommendation of the in-house bank which use information from macro-economics, capital markets and different divisions (cash) positions. The in-house bank also plays a general role as sparring partner on financial issues facing divisions, 2) agency: the in-house bank actually transacts with external banks directly on behalf of company's divisions. As the in-house bank does these transactions for the whole company, lower transaction and administration costs and a better negotiation position vis-à-vis banks are possible, and 3) banking: here focus is on the net trades that the in-house bank does with an external banks, i.e. the residual risks stemming from positions taken by divisions. A group view is applied. Also activities in intercompany transactions[3] are performed. These responsibilities result in the following activities: (Hommels, 1995, Bereuter, 1995):

- Provision of capital: required by the business, including negotiating the procurement of capital maintaining the required financial arrangements[4]

[1] The company is seen as a firm active outside of the financial services industry, e.g. a manufacturing firm.
[2] In order to establish an in-house bank, the following issues have to be covered (Hommels, 1995, p.303):
- Value-orientation: the in-house bank delivers better results than an external bank
- Risk profile: what level of risk, e.g. stemming from refinancing, is appropriate
- Client interfaces: structure and processes between the in-house bank and its internal clients
- Range of activities: with an orientation towards value creation, activities should be analysed and benchmarked so as to make sure loss-generating activities do not proliferate
- Information technology: systems must deliver transparency always and support professional services.

[3] I.e. transactions with subsidiaries.
[4] This should include internal clearance of divisional positions in various currencies and to perform transactions on the external capital markets when needed including hedging activities.

- Investor relations: to establish a market for the company's securities and, in connection therewith, to maintain adequate liaison with bankers, financial analysts and shareholders
- Short-term financing: to maintain adequate resources for the company's current borrowings from commercial banks and other lending institutions
- Banking and custody: to maintain banking relations, to have custody of and disburse the company's money and securities and responsibility for financial aspects of real estate transactions
- Credits and collections: to direct the granting of credits and the collection of accounts due to the company, including the supervision of required special arrangements for financing sales, such as time payment and leasing plans
- Portfolio management: to invest the company's funds as required, and to establish and co-ordinate policies for investment in pension and other similar trusts
- Tax: to optimise the tax charge by management of payment traffic through low-tax jurisdictions.

An industrial firm may indeed choose to diversify in banking and pursue a banking license to open up a bank. Normally, a company will want to avoid extra regulation and only do financial activities, which are in line with operational strategies.

c) Reason for the rise of in-house banking

Although we see an increase in the sophistication of corporate financial skills and capabilities, which support the development of in-house banking, macro trends have enabled in-house banks to rise to prominence[1] (Hommels, 1995 p.12):

- Globalisation: the tendency of integration of national and international financial markets enables an increase of (influence of) foreign investors in national markets[2] resulting in decreased dependence of firms on financial institutions
- Deregulation: the dismantlement of disadvantages for foreign firms on local markets by price-distorting legal and fiscal barriers enabling increasing competition
- Innovations in and development of the financial markets: the more disseminated use of financial products and processes which themselves have been tailored to more practical uses, and the availability of more and co-operating markets in different types of products
- Progressing information and communication technology: the increased networked market places result in greater market transparency and less information

[1] Bereuter (1995, p.43) notes that also upswings in the economic cycle have an effect on the creation of an in-house bank, as the management of liquidity becomes an important issue to firms.
[2] These ‘foreigners’ do not offer services to local firms but only create efficiencies in national markets.

asymmetries; also more data becomes available resulting in higher quality decisions; furthermore transactions become cheaper and faster

- Separation of physical and financial markets: traded volumes on financial markets are higher then on physical markets, which implies that transactions are more often financially driven; grounds for these transactions include international investing activities, risk management and speculation.

3. Interfaces between financial conglomerates and in-house banks

In-house banks of industrial firms require various types of products from financial conglomerates. More importance is laid on the fee-based advising business and less on the interest spread generating business. In-house banks and financial conglomerates have various interfaces (Bereuter, 1995, p.237ff):

- Commercial banking: deposits, credits, payment traffic, trading, guarantees etc.
- Investment banking: transactions on the capital markets (primary and secondary), application of derivative products for risk management, financial engineering, etc.
- Trust banking: investment, trust and wealth services such as consulting, analysis
- Service functions: insurance, credit cards, property services, consulting, etc.

These interfaces between banks and clients take place on different levels and between different organisational and often regional units. In choosing a bank, an in-house bank of an industrial firm would make an overall analysis of the banking relationships[1]. The upcoming of in-house banking means that the negotiation position of financial services firms has worsened.

III. The supply of financial services via the internet

1. Effects of the internet on the financial services industry

The internet is a series of communication protocols that support network interoperability with universal connectivity, communication and instant information. Electronic commerce (e-commerce) on the internet operates continuously and increasingly automates the processes of searching, buying, selling, producing and distributing. On the internet, buyers might have more power than in physical markets because they can compare prices and they also have more choices. Sellers are eager to learn information about buyers' preferences, and are willing to offer something in return. The size of the seller becomes less important as barriers to entry lower. A financial services firm, at its

[1] In choosing a bank, Bereuter (1995, p.265) distinguishes between two types of criteria: 1) bank specific criteria such as size, branch network, foreign presence, response time, flexibility, product scope, interest rates, security, quality, credit worthiness, image and personal relationships, and 2) business specific criteria such as credit conditions, banking skills, payment services, deposits conditions, trading conditions, foreign services.

core, is about controlling the flow of money and financial information. On top of that, relationships are built. In financial services, e-commerce can be seen as the entire set of transactions, internal processes and payments that are enabled, originated or delivered electronically, especially via the internet. The combination of technology, connectivity, availability and affordability is fundamentally influencing the balance of power: financial services firms no longer have near-exclusive control over the flow of money and information. Financial services firms used to be defined by their physical presence. But now traditional "bricks and mortar" become not as important as before and connectivity allows clients to ignore the walls, to pull apart firms' capabilities and rebuild in a way which suits them best. The internet may create a world where every financial institution is a specialised provider of products. A world of specialist banks may mean the end of the practice of cross-subsidising big clients in the interest of the overall relationship[1]. Joining in internet-banking are non-financial institutions. Microsoft, for example, has a joint venture with Itochu of Japan to develop an on-line share-dealing platform in Japan. New entrants into brokerage in the US include Charles Schwab[2], with market share of 25 percent, E*Trade[3], with market share of 15 percent, Datek Securities, with market share of 10 percent and Ameritrade, with market share of 9 percent (Euromoney, 1999, p.53); these firms did not exist before 1995.

WR Hambrecht, an internet based investment bank, plans to make the pricing of initial public offerings more of a science by using algorithms to find the optimal price based on orders received. Due to lower costs Hambrecht charges less than the standard 7 percent. Another example is AOL, an internet service provider, which has teamed up with retail internet investment bank Wit Capital in the US, adding 17 million potential accounts to the bank's client base. Wit Capital, 20 percent owned by Goldman Sachs, seeks co-lead manager mandates on initial public offerings to sell shares to those retail clients. Another interesting example forms E-loan, an on-line provider of mortgages. Its website allows borrowers to search more than 50,000 products offered by 70 lenders and receive, according to E-loan, unbiased recommendations. It also reckons it removes half of the costs by removing the need for a commissioned loan agent. Forrester Research reckons the US market for online mortgage originations will grow from US$ 18.7 billion in 1999 to US$ 91.2 billion in 2003 (Euromoney 1999, p.78). Egg, a UK internet bank, which started in October 1998 and is majority-owned by Prudential, reported that the number of new clients is still growing rapidly: in 2001, Egg won over 600,000 new customers, totalling 2 million. Early 2002, Egg declared itself sustainably profitable (Armstrong, 2002). Retail investors, empowered by the internet, are fast becoming

[1] That will mean transparent pricing in each business area as opposed to the distortions that are evident today.
[2] For an analysis of Schwab, we refer to Dewan & Mendelson, 2000, p.195ff.
[3] E*Trade is an example of a successful internet bank, which acquired operations such as telephone banking, mortgages, credit cards, and an ATM-network; a partnership with a chain of stores provides a presence (Orr, 2001, p.42).

much more proactive and influential, at least in US equities. Financial services firms fear that they lose privileged access to information, which financial services firms can use for their own purposes. Anonymity in trading systems means that even the largest fund paying the most commission will have to pitch in with other, smaller, funds. For financial services firms, e-commerce cannibalises existing businesses, especially in highly liquid and commoditised businesses, but it can also serve to expand markets.

2. Reactions of financial institutions to the internet

Using legitimacy of the "bricks and mortar" financial services firms, first mover entrants facilitate the emergence of an e-commerce industry[1]. By using a combination of this form of legitimacy and the legitimacy of internet-only partnerships[2], incumbents are more likely to survive the competition of fast progressing entrants and lead in an emerging e-commerce industry (Hensmans et al, 2001, p.239ff). Although this can be seen as an attempt to split the market among them, it also means that financial service companies are looking for ways to get capabilities and resources to be able to cope with the internet. Most of the leading US banks have set up e-commerce steering committees. Those banks seem to be following the same broad agenda (Euromoney, 1999, p.62): to consolidate any e-commerce-related initiatives into one co-ordinated effort, to drive forward all proprietary developments, to evaluate all approaches made to the financial services firm seeking partnership and/or funding, and to examine any consortium-based initiatives that the firm should be involved in. Nowadays major financial services firms all have an internet operation. At the same time we see banks going into other internet-related business as well. Different chances for financial services firms come up as well. By offering real-time credit checks while the on-line order is being made, financial services firms can put themselves into the transactions of internet shops. Another case in point is Merrill Lynch. In July 1999, Merrill Lynch announced an agreement with Works.com to enter the procurement business[3]. Wells Fargo Bank has launched a similar service. This bank also offers the service of electronic filing of tax returns[4]. Financial services firms initially wanted to move as many of their services and products online as possible. Now, before launching new internet efforts, banks are asking what products the marketplace wants, deciding whether they can effectively deliver them or not, and analysing if they can make extra profit or reduce cost with internet offerings. At

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[1] Electronic banking operating costs are estimated at only 25 to 30 percent of the cost of providing traditional banking services through bricks and mortar branch offices (Klinkerman, in: Hensmans et al, 2001, p.232).

[2] E.g. in 1999, Barclays Capital, a UK bank, joined Tradeweb, an electronic government bond trading vehicle initially set up by Lehman Brothers, Credit Suisse, Goldman Sachs, and Salomon Brothers; Merrill Lynch and JP Morgan are also associated. Effectively, Tradeweb is eroding the advantages the US banks have had by allowing non-US banks to compete on a level playing field. JP Morgan Chase provides cash management and treasury advisory to large corporate and institutional clients globally, and middle-market clients in the US.

[3] This business is seen as a potentially lucrative way of tying small/medium-sized firms to the brand because the bank manages the customers' transactions.

[4] A requirement under US law for firms with more than US$ 50,000 in payroll taxes (Moules, 1999, p.87).

present the online products offered by banks don't necessarily work well together or make sense. Many financial institutions have struggled to link existing legacy systems to the real-time, personalized nature of the internet, and to integrate websites with bricks-and-mortar operations (Murphy, 2001, p.8).

3. Uncertainty of the internet in financial services

To what extent e-commerce becomes a threat to financial services remains to be seen for three reasons (Euromoney, 1999,p.60): 1) the ability to gain business often depends on the ability to form relationships with clients, 2) banking is a highly regulated industry, which therefore knows entry barriers, and 3) the amount of capital needed to do business in the capital markets can be prohibitive.Due to the speed in developments in this field, it is unclear how regulation should act. Countries have committed to the general principles of the Basel Committee on Banking Supervision (BIS, 1999c) and will need to assess if these developments lead to changes in regulation policies. Given the prospects for the internet, there are still some barriers to overcome as can be seen from Figure 2 (GIG/ADL in: Engler & Essinger, 2000, p.40). Musto (in: O'Brien Coffey, 2001, p.38) reported that customers, who are shopping for financial products online, prefer the internet to other channels for routine customer care. These customers are interested in new online services that banks are rolling out en their number in the United States has increased from 6.1 million in December 1999 to 13.6 million in December 2001; based on demographic profile and further innovation the potential is estimated at another 16.3 million customers. Cross-selling becomes the apparent strategy for financial firms. Looking to future developments given the recent downturn in internet activities but the present potential, Grief et al (2000) give the following guidelines for financial services firms:

- Keep options open and don't choose to pursue only one option; this includes making several investments, forming alliances and push some and abandon other
- Have an open-mind to new pricing strategies: financial service providers must be agile and flexible in their approach to pricing without succumbing to the temptation to buy market share at unprofitable prices; at times, it may make sense to sacrifice short-term profits to build the online business for the long term
- Focus on customers' needs and dissatisfactions: online business provides the advantage of gathering vast amounts of customer data; interpretation is essential
- Leverage the assets of the traditional business, specifically assets such as brands, client relationships, distribution networks
- Be creative in rethinking organisational structures and management processes.

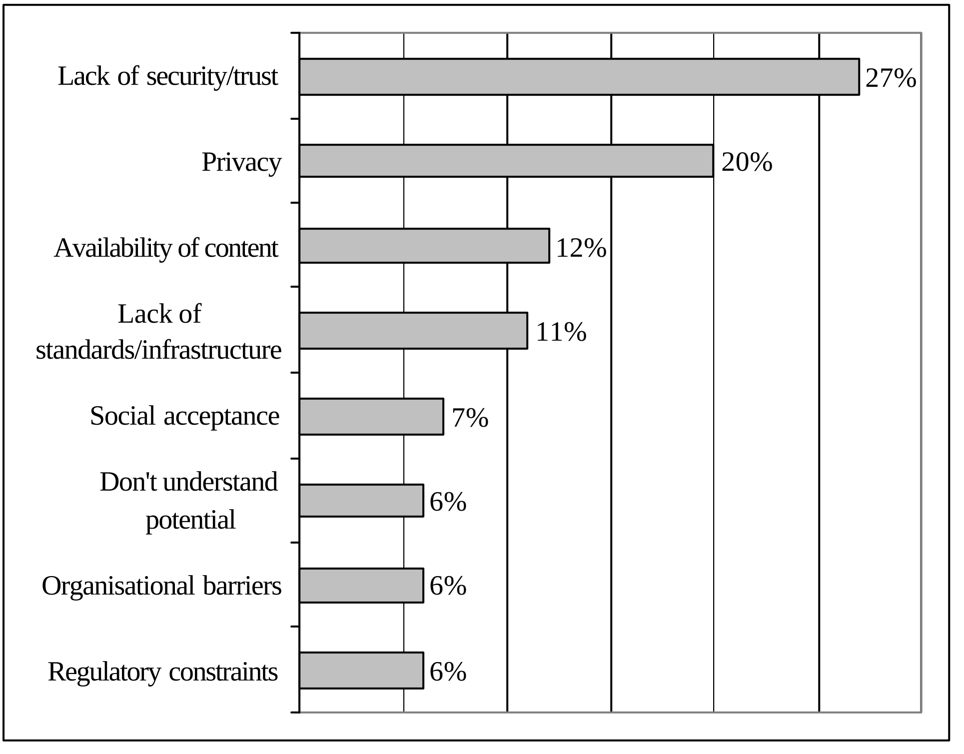

Figure 2: Barriers to adoption of internet commerce

B. Financial conglomerate structures

I. Universal banking and prototypes of financial conglomerates

1. The debate on universal banking

Introducing a scale, we can say that on one end of that scale we find the specialised financial institution, such as a brokerage or a life insurance firm offering one (type of) service to one (type of) client locally. On the other end of the scale, we find one conglomerate firm, which offers all financial products available, serving all clients on a global scale. In this research, we focus on financial conglomerates and therefore, we will focus our attention to understanding this form.

Mostly, performing different financial services to a mixed group of clients is called *universal banking*. Saunders & Walter (1994, p.74) and Smith & Walter (1997, p.426) define a universal bank as a bank with a high degree of integration of banking and securities activities[1]. Most of the financial conglomerates have a strong home market presence and operate only globally in specific areas, while building a worldwide presence for specific clients. Due to the nature of the activities, financial conglomerates are large as measured by total assets. Size conveys certain comparative advantages on both the funding and asset sides of activities of the financial services firm[2]. To what extent a bank can be called a financial conglomerate or not, is open for discussion: this is the question on how wide that range of financial activities can or should be (see also Vander Vennet, 1998). This question will not be answered here. Nevertheless, in order to be able to cover firms with that wide range of financial products, be it advice or funds, and clients, be it corporate, private or public, and acting internationally, in one or more countries, and within that class belonging to the biggest firms, as measured by assets or market capitalisation, we will refer to them as financial conglomerates[3].

[1] More specifically defined, universal banking can be seen as the conduct of a range of financial services comprising deposit-taking and lending, trading of financial instruments and foreign exchange (and their derivatives), underwriting of new debt and equity issues, brokerage, investment management and insurance underwriting and brokerage (Saunders & Walter, 1994). In Germany this conduct is called *Allfinanz* and in France *Bancassurance* (Saunders & Walter, 1994, p.204, Schierenbeck & Hölscher, 1992, Smith & Walter, 1997, p.105, Santomero, 1996, p.417). Calomiris (1996, p.109) sees universal banking as an intermediate technology in which the same intermediary provides a broad range of services to suppliers and users of funds - including deposit taking, lending, underwriting, risk management, and portfolio management.

[2] For example, large size is linked to the ability to undertake major transactions and the ability to fund cheaply in the wholesale and retail markets. It may also be linked to portfolio diversification and perceived credit quality issues. On the negative side, size brings with it the potential for complexity and inertia that can be a serious disadvantage in dynamic financial markets.

[3] Note that this is a definition driven by business/managerial objectives. Legal, regulatory and other considerations, although relevant, are exempted. As we have seen in part 1.A, new organisations, not based on other then business objectives and which cannot be typified as banks, help shape and change the financial services industry.

2. General overview of prototypes

Due to different reasons, financial conglomerates appear in a different manner in different regions of the global economy. Countries with legal systems based on English common law are more likely to have market-based financial systems than countries with other legal origins (Demirguc-Kunt & Levine, 2000, p.26)[1]. These countries tend to stress the rights of minority shareholders with beneficial implications for securities market development (LaPorta et al, 1997). Countries with German legal foundations tend to stress the rights of creditors to a much greater extent than other countries (LaPorta et al, 1998). Different legal systems treat equity and debt contracting differently. A major force driving appearances is local regulation. We distinguish between four types (Smith & Walter, 1997, p.427ff) as shown in Figure 3 on page 27.

3. The fully integrated financial conglomerate

This conglomerate is capable of supplying the complete range of financial services from one entity. As this variant has no regulatory obligation to fragment the production of its services this variant should be able to produce any given mix of output at the least cost (Herring & Santomero, 1990, p.481ff).

II. Non-fully integrated financial conglomerates

1. The German variant

a) General description

In Germany, the term *universal bank* is applied to the major classification of the financial conglomerates to distinguish these from the specialised ones, which only provide one type of financial service. In its appearance, this variant approaches type 1.

[1] In a paper discussing countries' financial structure and economic development, Demirguc-Kunt & Levine (2000) compare different factors in explaining why countries have a bank-based or market-based system. Although this is not the focus of this study, it is noteworthy to take notice of their conclusions:
- Countries with strong accounting standards tend to have market-based financial systems and are unlikely to have underdeveloped financial systems
- Countries with regulations that restrict the rights of banks to engage in securities market activities, real estate, and insurance are more likely to have underdeveloped financial systems
- Countries with explicit deposit insurance systems are less likely to have market-based financial systems.

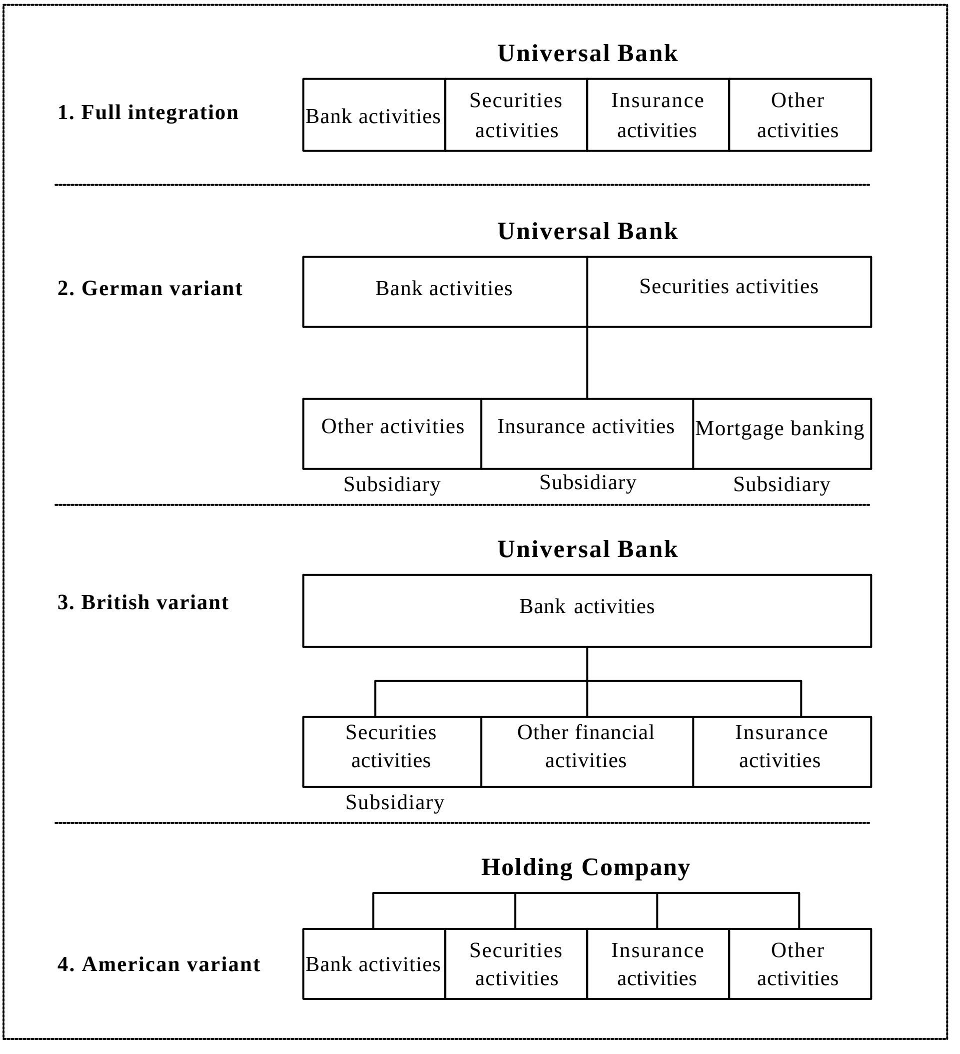

Figure 3: Four types of universal bank organisational structures

German banks are allowed to offer all types of financial services from one legal entity, except for insurance products, which must be marketed by a separate capitalised subsidiary. The distinction stems from the fact that this subsidiary is subject to the insurance law and supervised by other authorities. Although this possibility exists for a number of years in Germany, only the Deutsche Bank has a wholly owned life insurance subsidiary. Most of the other banks have strategic alliances, with or without equity stake, with insurance companies where the bank sells a range of insurance products and the insurance companies use bank products such as pension plans or mutual funds. In general, under German banking statutes, all activities can be carried out within the structure of the parent bank except for insurance, mortgage banking, building savings activities, and mutual funds, which require legally separate subsidiaries. It is not implied that German universal banks are completely free to pursue all financial services activities. There are three broad classifications of German universal banks: 1) commercial banks: these banks' activities span virtually the entire range of commercial and investment banking 2) savings banks, and 3) co-operative banks. Three aspects characterise a Ge rman universal bank: the preferred bank concept (Hausbank), an equity stake in non-banks and corporate control, and proxy voting of depository shares.

b) Characteristics

In the preferred bank concept, a company relies on one principal bank for all it's financial services. The relationship is two sided from the company: they have a partner who also in less prosperous times might be prepared to provide financial backing. Even if the company collapses, the debt can be converted into equity and the bank can take over control. The bank ensures itself with a long standing business relation and all of the banking business of its client. German universal banks often have equity stake in companies ranging from less then 5 percent to more then 50 percent (Canal, 1997, p.162, Steinherr & Huveneers, 1989a). In many cases these equity stakes give banks a seat on the supervisory board. Further, many retail clients have deposited their stocks at the bank. Share custody is a common service in Germany and although theoretically the ultimate shareholder exercises the voting rights, the banks exercise votes belonging to shares held in deposits; this is called proxy voting. This gives the German universal bank a several times larger influence on a corporation then their proportionate share.

2. The British variant

a) General description

This is the variant under which the financial services firm focuses essentially on commercial banking and all other services, including investment banking and insurance, are carried out through legally separate subsidiaries of the bank with dedicated capital. Legal separateness will entail some efficiency costs, and so the cost of producing a given mix of financial services may be higher than under the first and second variant. There are two offsetting advantages (Herring & Santomero, 1990, p.225ff). First the corporate structure separates non-banking activity and is more likely to result in functional regulation, which would reduce the costs of regulatory oversight. Second, in principle, this variant protects the bank from disastrous outcomes in other activities undertaken by the conglomerate while permitting it to benefit from all positive return (if no guarantee was issued). In reality, this may be an overly optimistic view. It assumes that the profitability of the bank is unrelated to he performance of its subsidiaries. Two considerations argue against this assumption. First, if operational synergies are important, the profitability of the bank may be adversely affected by the collapse of the subsidiary. Second, the bank's reputation and its cost of funds may be adversely affected by the failure of its subsidiaries. Thus, the parent bank may have business reasons to support a faltering subsidiary beyond its capital investment. Market confidence that the bank will not exercise the option to walk away from a troubled subsidiary enhances the creditworthiness of the subsidiaries. This is an advantage to the parent bank insofar as it reduces funding costs for the conglomerate, but it may distort competition and prove costly to the regulatory authorities. The parent bank's access to the safety net of the lender of last resort may be implicitly extended to the subsidiaries. This may weaken market discipline and lower the cost of funding for a function organised as a subsidiary of a bank rather than as an autonomous corporation. Furthermore, if trouble occurs, the regulatory authorities may find that it is less costly (in the short run) to validate market expectations by assisting the parent bank in bailing out its subsidiary than to withhold resources from the parent and let the subsidiary fail. To mitigate this risk, the regulatory authorities may attempt to re-enforce legal separateness with operational separateness by requiring firewalls between the parent bank and its subsidiaries.

b) Characteristics

Historically, the British financial system has been a structured system with clear demarcations between different types of financial institutions. However, unlike other countries, this specialist structure has been due not to legal barriers to diversification, but more to self-imposed restrictions on the range of business, coupled with moral suasion pressure of the regulatory authorities, the Bank of England in particular (Llewellyn, 1996, p.161ff). The structure of the British financial system has shifted towards the universal banking end of the scale as financial institutions have steadily diversified into each other’s traditional territories. This move required no changes in the law or regulations: the driving forces have been competitive pressures, developments in information technology, and the evolving strategic objectives of financial institutions. After the "Big Bang"[1] in 1987, commercial banks were free to conduct the full range of

[1] The term "Big Bang" represents the deregulation of securities industry in London by the London Stock Exchange (LSE). LSE practice was based on a strict "single-capacity" rule, which meant that member firms were either brokers or jobbers (market makers) in securities (equities and government and corporate bonds, but not Eurobonds), but could not be both. Traditionally, member firms had to be partnerships, and the extent

securities business and, at the same time, became manufacturers, as opposed to just distributors, of retail insurance and pension products. Different to the German variant, British banks do not take equity stakes in their corporate clients and do not have voting rights (either directly or via proxy) in companies. Also doing business through a subsidiary is a formal requirement and not a free choice. Overall, the British approach of financial conglomerate structures is designed to secure the benefits of full diversification, while guarding against at least some of its potential hazards.

3. The American variant

a) General description

This variant is also known as the holding company structure, where a holding company owns both banking and non-banking subsidiaries that are legally separate and individually capitalised, insofar as financial activities other than "banking" are permitted by law. These may be separated by regulatory restrictions[1] if there are internal or regulatory concerns about institutional safety and soundness or conflict of interest. The holding company may also be allowed to own industrial firms or may be itself an industrial company. The main advantage of this variant over the British variant, is that the bank may have less incentive to bail out a faltering non-bank if it is an affiliate rather than a subsidiary. American regulation has attempted to accentuate this separateness on occasion by requiring firewalls such that an affiliate differs from the bank in name, in employees, in location, and in distribution networks. In part, these restrictions are aimed at reducing the potential loss of reputation to the bank if the affiliate should fail[2] (Herring & Santomero, 1990, p.485). In a 1994 study, Saunders & Walter (1994, p.204) concluded that for US banks there are potential risk reduction gains from allowing banks to expand their activities in a limited fashion and that these gains increase with the numbers of activities taken. The main risk-reduction gains appear to arise from banks' expanding into insurance rather than securities activities. More-over, quite substantial risk-reduction gains appear to exist at the most comprehensive level of universal banking, where the activities life and casualty insurance, commercial banking and securities brokers/dealers are being combined. In general, in this variant the cost of producing a given mix of financial products is likely

of external ownership (e.g. by banks) was strictly limited by the LSE's own rulebook. Changes, brought about in 1969 and 1982, allowed member firms to become limited companies, but a limit was placed on outside shareholdings in those firms. The government's decision to refer the LSE's rulebook to the Restrictive Trade Practices Court was the catalyst for change. Structural changes followed and in 1986, fixed commission ended and stock exchange rules were changed to allow 100 percent of outside ownership of stock brokering and jobbing firms (Llewellyn, 1996, p.181ff).

[1] Known as Chinese walls or firewalls.

[2] The Federal Reserve Board has traditionally advanced a "source-of-strength" doctrine, which implies that during periods of financial stress or adversity, the regulatory authorities should be permitted to use the resources of the holding company and force subsidiaries to support the bank.

to be somewhat more expensive than in other models. Also, according to Smith & Walter (1997, p.428), studies have suggested that the American variant incorporates a number of comparative disadvantages against various other forms of universal banking. The limiting factor here has been the Banking Act of 1933.

b) Characteristics

The Banking Act of 1933 has had severe consequences for the American variant and we will go into some detail. This act also has become known as *the Glass-Steagall Act*. The Glass-Steagall Act consists of four different sections of the Banking Act that separates commercial banking from investment banking[1]. The main two sections are section 16, which prohibits a national bank from dealing or underwriting securities and section 20 which defines that a Federal Reserve member bank can not be affiliated with any entity dealing with the "issue, flotation, underwriting, public sale or distribution of debt and equity securities not permitted in section 16". The objective of this law was to separate the banking industry from the securities industry so that if a major declination in the market occurred again, banks would not be in the same trouble that they were in during the depression. Another reason for this set of regulations was to limit the degree of risk that a depository institution could sustain in the assets it acquired and in the securities it offers to the public in order to raise funds. These constraints are most demanding for commercial banks, savings and loans, and credit unions. These limitations also apply to many non-depository financial institutions. Following these banking regulations in the early 1930s, the restrictions placed on financial institutions became much more severe. In light of the changing times, many changes have been made to the Glass-Steagall Act.

There have been many questions about different regulations that have been put into action. These regulations restrict the bank's business to the deposit-taking business only. Lending can be just as risky as securities underwriting. It seems that by diversifying the bank's business to more than one type of business, risk can be lowered, especially during periods of low demand or low profitability. Also, fluctuations in earnings power can be minimised (Garten, 1991, p.34ff). Another argument for banks to offer investment services is through looking at foreign markets. Since foreign banks can offer a variety of financial services, domestic banks need to be able to compete in these areas as the economy globalises. The banks decided that they needed to broaden the alternative financial services offered to corporate clients, not only to keep their credit clients, but also to keep those relationships. Therefore, a few large banks looked for different ways to get around this law. They found a loophole in section 20. It had originally been defined that banks were prohibited from certain activities but the large banks argued that it just limits these activities. Therefore, banks were allowed to

[1] These four sections are sections 16, 20, 21, and 32.

become engaged in some earlier ineligible securities such as municipal bonds, commercial paper, and mortgage related securities. This became known as section 20 tier I powers. Besides taking on other financial activities, banks anticipated changes in the legislation to formally allow further integration of financial services companies[1]. In 1999, the *Gramm Leach Bliley Act* was passed. This acts explicitly aims to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers. In effect, universal banking as described in the German variant comes into sight. In terms of international competitive performance, financial institutions that are subject to different organisational forms as a result of legal or regulatory barriers may suffer against those institutions that are freely able to choose their optimal organisational form. The fact that regulatory environments, which are totally unrestricted as to the organisational form of financial services firms, are home to so called "true universal banks" suggests that structure-related sources of institutional competitiveness do in fact exist.

III. The structure of a financial conglomerate

1. Matter of reach in efficiency, markets and products

The degree to which the same corporate entity may legally supply all types of financial services, but may also create separate subsidiaries or affiliates when warranted by market conditions, is increasing. Management has complete freedom to structure the organisation to achieve maximum comparative advantage, which may have to involve the creation of separate legal or functional entities, firewalls, or other forms of fragmentation. Under this arrangement, the optimum delivery system from the standpoint of competitiveness dictates the form of the organisation. In the view of Herring & Santomero (1990, p.492), the question of appropriate structure is really a question of how best to achieve economies of scope in production and consumption while minimising any extension of the safety net from the lender of last resort from the basic financial services business to other activities. According to Herring & Santomero, (1990, p.473), financial conglomerates are formed because owners or managers of financial services firms believe that they can achieve economies of scope that will make it more profitable to provide a range of services to a possibly larger client base within an integrated corporate group than to provide each service through a separately managed corporation, or because a financial services firm may be induced to diversify simply to gain economic power or comparative advantage through being bigger. If the bank secures either economies of scale or scope through diversification, competitive markets produce a sharing of these benefits between the firm and the consumer. Even the

[1] The 1998 merger of Citicorp and Travellers Group into Citigroup is an example of a move in that direction.

formation of the EMU can be used to increase efficiency in financial conglomerates, although this would not be straightforward and it would be restricted.

2. Separateness and restrictions

It is important to distinguish two different concepts of corporate separateness: legal and operational separateness (Stein, 1993). Legal separateness implies that different products are provided by separate corporate entities, each of which has its own management structure, set of accounts, board of directors, and capital[1]. In the absence of additional restrictions, the managers of a conglomerate may co-ordinate the activities of the separate corporate entities that they control and achieve many of the advantages of an integrated firm. Operational separateness implies regulatory or self-imposed restrictions that inhibit the integrated production of different products. Restrictions may prohibit flows of credit and information between different units and may require that different products be produced by different people at different locations and be distributed through different channels. Such restrictions inevitably reduce the extent to which a conglomerate and its clients can realise economies of scope in either production or consumption. If the restrictions are self-imposed, there is a presumption that clients value separateness more than savings that would result from more integrated production and distribution of financial products. If regulators impose restrictions, the rationale may be to prevent abuses of power, the contagious transmission of shocks, cross-subsidies, or an extension of the potential liability of the lender of last resort. In reality, a certain degree of corporate separateness may be desired even when it is not required, e.g. for the association with independence between activities in terms of operations, financing, and financial information flows (Herring & Santomero, 1990, p.488).

Further, limited liability gives the conglomerate the option of limiting losses in the event of a substantial shock to a particular line of business. Sometimes, tax laws even encourage the formation of separate subsidiaries in order to capture tax benefits that would be lost in a consolidated reporting of income for tax purposes. When a subsidiary is acquired rather than started by the corporate conglomerate, a certain degree of corporate separateness may be maintained in order to make use of the reputational capital of the acquired firm. Corporate separateness may facilitate managerial control, particularly if compensation practices for one kind of business are substantially different than for another. Similarly, corporate separateness may also be a useful way to deal with different business cultures. Finally, corporate separateness may be a useful way of assuring potential clients that they will be protected from conflicts of interest, which might otherwise put them at a disadvantage vis-à-vis other clients of the conglomerate or the conglomerate itself. Specialised financial services firms will continue to compete

[1] Shareholders are legally protected from bad outcomes in the separate corporate entity by limited liability.

effectively by using different production or delivery systems than their mass-market conglomerate competitors. They may also choose to specialise in activities or products in which economies of scope are less valuable. Concluding on these arguments, Smith and Walter (2000, p.15) expect that corporate separateness, i.e. the American variant, is going to be dominant for financial conglomerates in the future, splitting the landscape in centralised and decentralised forms of financial conglomeration.

3. Considerations on conglomeration

a) Synergies as seen from the firm's perspective

Literature hardly reports any evidence of the existence of economies of scope in financial conglomerates (Herring & Santomero, 1990). Only some research indicates economies of scope with large banks, especially through the economic use of information technology, the offering of a wide range of products, and through shared inputs. Berger & Mester (1997, p.18) report on weak evidence that banks in holding companies are more efficient than independent banks. In the case of diversified banks size does matter. The largest banks usually outperform their smaller competitors in terms of efficiency (Vander Vennet, 2000, p.158). Benston (1994) concludes that data on economies of scale and X-efficiency indicate some advantage for universal banks over specialised banks. If we now see holding companies as a prelude to a financial conglomerate, increasing efficiencies can be expected. Other reviews fail to find unambiguous support for economies of scope (Llewellynn, 1996, p.172). In a survey conducted for an OECD study (1993), the conclusion was:

On the basis of 108 studies carried out between 1982 and 1991, existing methodological approaches do not yield conclusive results as to the existence of significant economies of scale and scope in the financial services industry, and that, at the cost-efficiency level, the effects of organisational inefficiency (failure to attain cost control and management efficiency) are much more important.

Obviously, with developments of information technology, together with the new emphasis on cost control in banks, evidence on the basis of past performance may be a poor guide to potential future economies of scope. These may be realised whenever the cost of producing a given mix of products jointly is less than the sum of costs of producing each product separately. They are likely to be important whenever a fixed cost can be shared across products. Several factors would appear to give rise to economies of scope in the provision of financial services (Llewellyn, 1996, p.172ff)[1].

[1] Examples (in the footnote on page 35) include:

b) Synergies as seen from the client's perspective

Synergies may also exist in the consumption of financial services; users of financial services may value a package of financial services from a single source higher than the same array of products obtained separately from several different firms. In addition to realising economies of scope in production, the view that cross-selling products to clients increases profitability is based on the assumption that clients will be willing to pay more per product as the number of products obtained from a single institution increases. These economies of scope in consumption may, for the client, arise from a reduction in search, information, monitoring, and transactions costs, which may be realised when several financial products may be purchased from the same firm. Vander Vennet (1998, 2000) finds that financial conglomerates are more revenue efficient than their more specialised competitors and that the degree of both cost and profit efficiency is higher in universal banks than in non-universal banks[12]. Strategically speaking, financial conglomerates may also respond more flexibly and at lower cost to demand shifts and market conditions across financial products as client needs require, than other firms that offer only a limited menu of services or financial products (Steinherr & Huveneers, 1989b, p.8). Moreover, the perception of greater flexibility over time may be an advantage for which clients are willing to pay a premium. Diversification is then seen as developing a more intensive and extensive client relationship, with the potential to tie in the client to a more secure and continuing relationship. It could be that the more services a consumer purchases from a bank, the less likely the client is to shift between firms, due to high switching costs. Conversely, the more diffused a client relationship is, the greater is the risk to the financial services firm that the client will shift existing financial services business to other institutions. Also, the wider relationship a client has with a bank may enable the consumer to negotiate better deals. Just as the switching costs of moving a diverse account is high for the consumer, so the costs to the bank of

- The fixed cost of managing a client relationship may be shared across a broad range of financial services (Steinherr & Huveneers, 1989a, p.8)
- It might also be possible to use distribution channels established for one product to distribute other products at slight marginal cost
- Several services can be marketed simultaneously, and the bank may gain both a marketing advantage and a reputation or image advantage in being seen to be offering a wide variety of services
- Client information used to produce one product may be used for other products at little additional cost
- In terms of the financial services firm's risk profile, and depending on the nature, size, and correlation of risks, diversification has the potential to reduce portfolio risk in the overall business structure.

[1] Vander Vennet (2000) found that financial conglomerates and universal banks attain the highest cost efficiency levels, in comparison to specialised banks. This may indicate that technology spillovers and cost synergies are best achieved by a full form of organisational integration. Universal banks also show superior profit efficiency. With an exception of very large banks, he also found that cost efficiency is largely unrelated to size; the way individual banks are managed is dominant.

[2] Saunders (1994) argues that allowing banks to be acquired by other financial companies or even commercial firms would impose monitoring and creative incentives for efficiency and value-maximising behaviour. It would also reduce expense-preference behaviour, which has been found to be present in banking. Often, the formation of a financial conglomerate constitutes an occasion for focused rationalisation programmes, a phenomenon that also has been observed in EU bank mergers (Vander Vennet, 1996).

losing the account are greater. The consumer has the potential to exploit *relationship banking*. The implications for market structure differ if the motive for forming a conglomerate is economies of scope in consumption rather than economies of scope in production. If economies of scope in production are negligible, economies of scope in consumption could be exploited by using the distribution network of one institution to sell packages of financial services that are produced by others; Herring & Santomero (1990, p.475) call this an agency form of a financial conglomerate. To the extent that conglomerates have more scope to develop innovative new products and services in response to changing technology and market conditions, they may be better able to respond to client needs. Integrated conglomerates, within which information flows freely and incentives are harmonised, may have an advantage in meeting the changing needs of clients relative to either specialised firm or autonomous firms whose products are offered in joint distribution.

c) Diseconomies of scope and concluding remarks

Managers must weigh the potential economies of scope against diseconomies, which may jeopardise the efficiency of multi-business conglomerates (Herring & Santomero, 1990, p.475): 1) the sheer size of the bureaucracy that usually accompanies a conglomerate structure may be a disadvantage - the regulation and compliance costs of a diversified business may be very high, 2) the complexity of managing and developing several different kinds of business in one integrated structure may erode some of the potential economies of scope (The Economist, 1999, p.89), 3) clients may perceive disadvantages in the joint production of financial products, as they may be concerned that information they share with the conglomerate in one transaction could be used to their detriment in other transactions. Further, the consumer's image of traditional businesses may be contaminated by an unsuccessful venture into new areas, 4) according to Boot & Schmeits (1996, p.1), a major cost of conglomeration is less transparency and therefore a reduction in the effectiveness of market discipline. Due to an increase in opaqueness of the balance sheet of the financial services firms, outsiders cannot assess the performance of financial services firms sufficiently, and more importantly, have little control over the financial services firm, whereas managers may have excessive discretion[1], and 5) for public policy, the major interest in favour of allowing more diversification is that it enhances competition or contestability in

[1] The absence of market discipline may result in free-rider problems, since each division does not fully internalise the consequences of its own actions. The primary mechanism that Boot & Schmeits see for market discipline is the bank's cost of capital. Divisions should face a cost of capital reflecting the riskiness of their activities. In the extreme, with perfect or complete market discipline of stand-alone activities, conglomeration (in absence of synergies) is never optimal. However, with ineffective market discipline, conglomeration may or may not be beneficial. Introducing internal cost allocation schemes may create internal market discipline that complements the weak external market discipline of the conglomerate. These schemes should be dynamic and thus should respond to actual risk choices.

financial services, erodes any economic rents earned by existing firms in sub-sectors of the financial system, and minimises institutional risk. All in all, we can state that in practice, the advantages of financial conglomeration are not that clear and that good management is needed to bring about these advantages, as we find them in industrial firms. Walter (2000, p.79) summarises it as follows: *do not expect* too much from economies of scale, *do not expect* too much from supply-side economies of scope, and be prepared to deal with any diseconomies that may arise, *optimise* x-inefficiencies through effective use of technology, reductions in the capital-intensity of financial services provided, reductions in the workforce, etc., *exploit* demand-side economies of scope where cross-selling make sense, *seek-out* imperfect markets that demonstrate relatively low price-elasticity of demand, *specialise* operations using professionals who are themselves specialists, where possible, *make* the political case for backstops such as underpriced deposit insurance; shareholders clearly benefit from implicit subsidies, *pay* careful attention to limiting conflicts of interest in organisational design, incentive systems, application and maintenance of Chinese walls, and managerial decisions that err on the side of caution where potential conflicts arise, *minimise* the conglomerate discount by divesting peripheral non-financial shareholdings and non-core businesses, leaving diversification up to the shareholder, *get* rid of share-voting restrictions and pen-up shareholdings to market forces, *pay* careful attention to the residual value of the bank by avoiding professional conduct lapses that lead to an erosion of the financial service firm's reputation or uncontrolled trading losses.

C. Value-based management in financial conglomerates

I. Shareholder value as yardstick for the organisation

1. Introduction to the shareholder value concept

a) Basic premise of shareholder value

In a conglomerate a key issue is how divisions add value to the group. From the viewpoint of financial theory, according to Rappaport (1998, p.5), the only social responsibility of business is to create shareholder value and to do so legally and with integrity. This means that all actions of a company, and thereby also its divisions and the corporate centre, must be aimed at this value creation. Seen from a management perspective, one can also use shareholder value creation as a yardstick to measure how well the company is doing. Although, at a minimum, the survival of the company must be ensured, there does exist a zone between bankruptcy and absolute value creation leadership. This means there is room to give other interests a higher priority when necessary. Narrowed down, the shareholder value approach estimates the economic value of an investment by discounting forecasted cash flows by its cost of capital. These cash flows, in turn, serve as the foundation for shareholders return from dividends and share-price appreciation[1]. As an example, Table 3 shows an international cross-section of financial services firms, which, from the investor's viewpoint, created shareholder value (as defined as the sum of dividend and capital growth) (Barfield, 1998, p.26).

Firm	Banco Bilbao Vizcaya	MBNA Corp	Banco Santander	ING Groep	Citicorp
TSR (%)	55.9	51.9	47.2	45.1	43.1
Firm	Bank Boston	Bank of New York	Lloyds TSB Group	ABN AMRO	US Bancorp
TSR (%)	41.3	39.6	38.8	38.3	38.0

Table 3: Total shareholder value return (TSR) 1993-1998

Value creation can be captured in generic Equation 1 (Stewart, 1991, p.136)[2]:

[1] If an investor is considering buying equity and becoming a shareholder, the investor ought to take account of the opportunity cost of having capital tied up there rather than in a different stock with a similar risk profile as witnessed in the capital markets.
[2] Stewart uses the abbreviation EVA™ (Economic Value Added) for Economic Profit.

$$
\begin{aligned}
&\textbf{Economic Profit}\\
&= \textbf{Net Operating Profit after Tax} - (\textbf{Invested Capital} * \textbf{Weighted Average Cost}\\
&\quad \textbf{of Capital)}\\
&= \textbf{NOPAT} - (\textbf{IC} * \textbf{WACC})\\
&= \textbf{Invested Capital} * (\textbf{Return on Invested Capital - Weighted Average Cost of Capital})\\
&= \textbf{IC} * (\textbf{ROIC - WACC})
\end{aligned}
$$

Equation 1: General formula for Economic Profit

In banking, the debt component of the balance sheet is part of the daily business of the firm. We therefore have to modify Equation 1 and we focus on the cash flows to equity. This results in Equation 2 in which economic capital[1] reflects the risk-adjusted equity (Paul, 2001, p.38, p.102ff). The cost of equity reflects the specific level of risk in the firm and can be calculated as shown in Equation 3:

$$
\begin{aligned}
&\textbf{Economic Profit}\\
&= \textbf{Net Operating Profit after Interest and Tax} - (\textbf{Economic Capital} * \textbf{Cost of Equity})\\
&= \textbf{NOPAIT} - (\textbf{EC} * \mathbf{c_{eq}})\\
&= \textbf{Risk Adjusted Return On Capital} * \textbf{Economic Capital}\\
&= \textbf{RAROC} * \textbf{EC}
\end{aligned}
$$

Equation 2: Formula for Economic Profit in banks

For long it was thought that only functional excellence created value. Thus, a financial services firm that excelled at, e.g., origination, distribution, servicing, or making markets was considered likely to succeed in creating value for its customers and ultimately for its shareholders. However, functional excellence is not enough. Financial conglomerate strategists increasingly share the view that a focus on customers in terms of anticipating, understanding and responding to their needs rapidly and efficiently, and ultimately establishing enduring relationships between service providers and customers, creates value that is sustainable and often difficult to imitate (Melnick et al, 2000, p.5ff).

b) The debate on methodologies

Measuring shareholder value creation is of utmost importance and there is a need for methodologies by which companies and divisions can be analysed, re-oriented and then managed to conform to a value creation imperative. In many cases, we see that accounting-based numbers, e.g. earnings, are used to measure corporate and divisional performance. Earnings, however, fail to measure changes in the economic value of the firm as alternative accounting methods may be employed, as investment requirements and the time value of money is excluded: research has shown that historical accounting earnings and stock market performance have little correlation (Rawley & Lipston, 1985). Measuring corporate and divisional performance with accounting numbers

[1] For a review of methodologies for allocating economic capital within a bank, we refer to Paul (2001)

therefore might lead to ill-advised decision-making. In contrast, the relationship between cash flow and share price is significant (Black et al, 1998, p.45). Different methods for measuring shareholder value creation treat the source data on cash flow and capital to show different aspects of value[1,2].

c) Business risk as a central component of shareholder value

Another important aspect of shareholder value is the notion of business risk, i.e. the risk inherent to the company and to the division. The compensation for business risk is reflected in the cost of capital for a firm or a division, be it debt or equity. In order to calculate the cost of equity, we use the Capital Asset Pricing Model (CAPM), which says that the investors' expected return (E(r)) is the sum of a risk-free rate (R_f) and an equity risk premium (R_p) (Ross et al, 1999, p.257ff). The equity risk premium (R_p) is a product of the positive difference between the average market return (R_m) and a risk free rate (R_f), and a company or division specific risk factor (ß), which is the relation between a) the covariance between the return of the asset (e.g. the stock of a company) and the return on the market portfolio, and b) the variance of the market. In Equation 3:

$$\mathbf{E(r) = R_f + R_p = R_f + ß * (R_m - R_f)}$$

Equation 3: Capital Asset Pricing Model

In essence, CAPM argues that the received and expected returns are related to the risk incurred by owning particular financial assets. One key insight is that there is a risk-weighted discount factor, which allows for assessment of the value today of developments and cash flows later. This discount rate is derived from capital markets observations and defines what the opportunity cost is.

[1] Implementing methodology: free cash flow in a financial institution can be thought of as the dividend paying capacity of the business (Black *et al*, 1998, 153ff). This is not the same as cash flow in an accounting sense. The logic for this approach is that banks have specific regulatory requirements, and banks cannot, except with special permission, issue dividends to the extent that capital is reduced. In that respect value drivers, in the categories growth, returns and risk, can be identified. The model for a bank differs from other sector models specifically in the treatment of the capital adequacy adjustment, as growing the balance sheet involves ensuring that there are adequate reserves to meet regulatory requirements; qualifying capital therefore is more appropriate than tier 1 capital – this influences the weighted average cost of capital. Black *et al* (1998, p.151ff) give a hint how to apply shareholder value models for activities in banking, insurance and fund management.

[2] Well-known methodologies include:

- Cash Flow Return on Investment (CFROI), developed by Holt Value Associates
- Economic Value Added (EVA™), developed by Stern Stewart & Co
- Free Cash Flow (FCF), developed by McKinsey & Co
- Shareholder Value Added (SVA), developed by LEK/Alcar Consulting Group
- Value per Share (VpS), developed by Schierenbeck (1997), see Figure 63.

The differences between these methodologies lay a.o. in the treatment of certain accounts but their common focus is on calculating a return which should be higher than the cost of capital. Most start with corporate finance theory as developed by Modigliani & Miller in 1961, whose work addressed the measurement of corporate performance and the relation with market valuation. The Value per Share method starts with the familiar DuPont scheme.

2. On value-based management

a) Introduction to value-based management

Value-based management (VBM) is based on the insights of shareholder value creation. VBM is present when all activities within the financial conglomerate are focused on the sustained long-term improvement of the value of the equity (Schierenbeck, 1997b, p.422). VBM takes these insights further by focusing on how companies use them to make major strategic and everyday operating decisions (Copeland et al, 1996, p.96). Properly executed, VBM is an integrative approach to management whereby the financial conglomerate's overall aspirations, analytical techniques, and management processes are all aligned to help the financial conglomerate maximise its value by focusing decision making on the key drivers of value. The first step in VBM is embracing value maximisation as the ultimate financial objective for the financial conglomerate. Furthermore, management must know how this financial objective weighs in against other objectives. In general, financial conglomerates must have two sets of goals: financial goals and inspirational non-financial goals, which motivate the performance of the entire organisation[1]. Non-financial goals, however, must be carefully considered in light of the financial circumstances. Objectives must be tailored to the level of the organisation. For the division head objectives will have a different performance measure, probably more value-explicit than for a subordinated team leader.

b) Identification of value drivers

An important part of VBM is a deep understanding of what performance variables will actually drive the value of the business. Copeland et al (1996, p.106ff) call these key value drivers. There are two reasons such an understanding is essential. First, the organisation normally cannot act directly on value. It has to act on things it can influence, such as capital expenditures, cost, etc. Second, it is through these drivers of value that senior management learns to understand the rest of the organisation and to establish a dialogue about what it expects to be accomplished. Responsibility for the performance of these value drivers can be assigned to managers who can help the organisation meet its targets. Value drivers must be developed down to the level of detail that aligns the value driver with the decision variables directly under the control of line management. Generic value drivers apply equally well to nearly all divisions, but lack specificity and cannot be used well at all levels (Copeland et al, 1996, p.107). Value drivers are not static, but must be periodically reviewed. To understand interrelationships among value drivers, Copeland et al (1996, p.111ff) advise to employ scenario analysis. Scenarios represent the value impact of different sets of mutually

[1] These may include goals about customer satisfaction, product innovation, and employee satisfaction.

consistent assumptions on the value of a company or division. They help top management to understand the relationship between strategy and value. Value drivers and scenarios make VBM fact-based by linking actions to their value effect of the firm.

c) Implementing value-based management

Because VBM requires a change in mindset for decision makers at all levels, it can be a long and complex process. Figure 4 can help managers put the change process in perspective by helping them understand where their company is today in VBM terms (Copeland et al, 1996, p.120ff). Six characteristics measure how deeply VBM informs an organisation. To what extent is it performance driven, value-based, managed bottom up and top down (see dual control approach further down), using two-way communications, using self-reinforcing incentives, and low cost? These characteristics capture both the "hard" and "soft" elements of VBM. Figure 4 shows a spider web diagram in which an example firm scores[1].

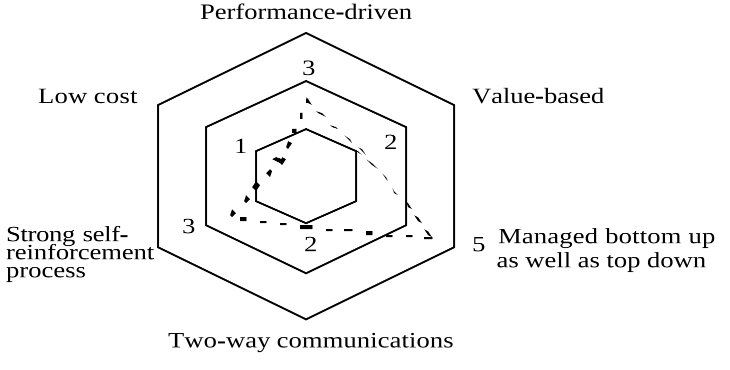

Figure 4: Six conditions for VBM

The cornerstone for implementing VBM is the so-called *triad of VBM in financial conglomerates* (Schierenbeck, 1997b, p.1ff). The primacy of profitability applies here, i.e. all operational and strategic business decisions have to generate an appropriate minimum profitability. In this context, the growth of a company serves equally as a means of increasing profitability (value-oriented growth policy) and as a means of taking on risk (value-oriented risk policy). An integrated controlling policy, based on this philosophy, steers a financial conglomerate towards a value-oriented approach at

[1] 5 is a high score, 1 a low score.

the group level, the division level and at the level of individual transactions. In terms of company policy, controlling inevitably takes on a coordination function. Value-oriented business philosophy is the *first* core element, derived directly from the basic philosophy of value-oriented financial services management, and can be defined as a management concept that focuses first and foremost on income (Schierenbeck, 1997b, p.6ff). The financial conglomerates results are always put at the centre of all business policy deliberations at all levels of the financial institution’s hierarchy. Profitability is the prime concern, with growth and risk policy subordinated as means of supporting profitability. This philosophy requires institutionalised cost control and cost reduction in the sense of continuous productivity improvement as part of a lean banking concept, which we will discuss in paragraph 1.C.I.3.c. Customer benefit banking aimed at the systematic development of competitive advantages within the chosen customer target markets, is also required. The performance-oriented design of operational incentive systems and the synchronization of bank-wide goals with individual compensation and career goals represent another element of this first key component. Goal-oriented management, as *second* part, supported by planning, decision, implementation, and control, as shown in Figure 5 (Voegelin, 1999, p.8), requires the procurement, storage, processing, transmission and dissemination of information.

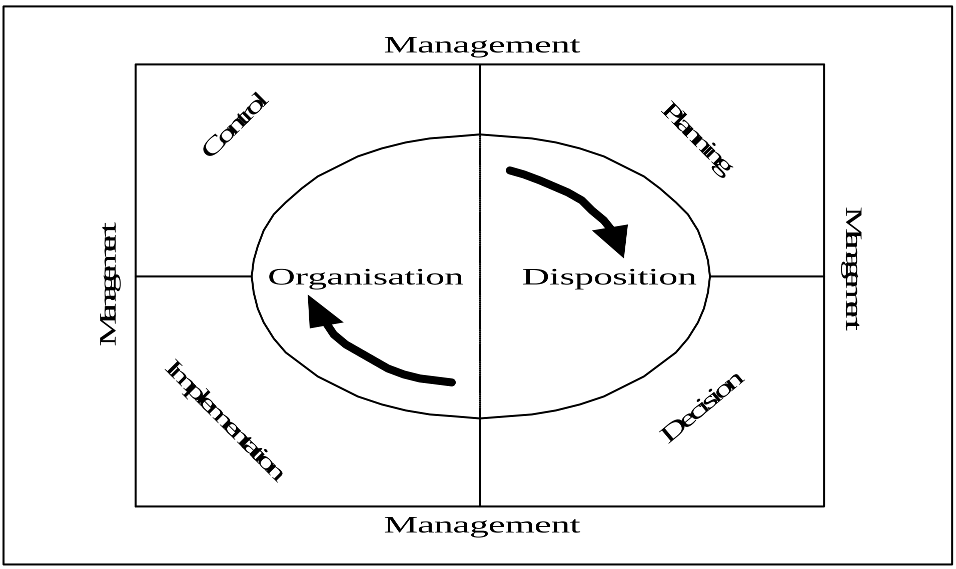

Figure 5: Constituting elements of management

The controlling process links planning and control in a hierarchically interconnected cybernetic control loop model (Schierenbeck, 1997b, p.11): 1) planning is done according to the so-called *counter flow* process, which is a combination of going bottom-up and top-down, and 2) controlling goal achievement and variance analysis are done based on a “management by exception” strategy. This assumes a high degree of self-controlling. When these points are taken into account we get to a *dual control* approach. This can be characterised as in Table 4 (Schierenbeck, 2001, p.91ff).

Profitability control	vs Risk control
Broad control focused on potential	vs Narrow control focused on action
Portfolio and balance structure control	vs Business control
Centralised control	vs Decentralised control

Table 4: Dual control model

There has to be an appropriate organisational and operational structure for the institutionalised controlling cycle to work properly – this is the *third* part. As in the planning and control area, a distinction has to be made within the corporate structure between decentralised market areas and central specialist departments. The former have to be organised with a focus on customers and markets. The latter take care of central tasks. Perhaps most important amongst these are management of the business portfolio and of the balance sheet structure. These centralised units can also take on servicing and processing jobs for the divisions. The *final* element in a value-based controlling concept is an information system for the financial conglomerate’ management. This system has to ensure that decision-relevant information is available at all levels of the financial conglomerate. The main supplier of quantitative information for the management information system is the operational accounting system. A management information system, the *fourth* and last part, has to be able to provide transparent information about how much money a particular transaction earns, taking into account terms and conditions, risk and volumes - this is called the reporting function. Secondly, the management information system has to help managers make decisions by informing them how much income individual transactions have to generate, or what the minimum revenue is before the transaction makes a profit, again taking into account terms and conditions, degree of risk and volumes – this is called the decision support function.

3. Value orientation by using the profit centre concept

a) Characteristics of the profit centre concept

According to Meyer (1995, p.4), the profit centre has an independent responsibility for its own results, which forms the organisational framework for active (financial) management. He mentions the following advantages of the profit centre concept:

- The creation of smaller, more comprehensible organisational units improves the management of the financial conglomerate as a whole
- The division of units into results-oriented profit centres enables faster and more flexible response to changes
- Greater transparency in costs and revenues enhance earnings orientation
- The motivation of managers and staff improves as a result of direct responsibility for profits
- The evaluation assessment staff is carried out on the basis of performance.

Two basic features of the profit centre concept become apparent: responsibility for results and independent decision-making. Table 5 shows that various types of responsibility, all of which are subsumed under the profit centre concept, which can be identified depending on the nature of these goals (Kaplan & Atkinson, 1989, p.529ff). Profit centres can be established according to different criteria. This permits the various hierarchical levels of results to be linked to the hierarchy of the company, which means that individual departments' operating results at each level can be aggregated. This is significant for management accounting as an information tool. Moreover, these are profit centres in the strict sense, and the individual divisions are therefore not able to make investments without approval, though they are accountable for success.

Type of profit centre	**Responsible for**
Cost centre	Service production
Revenue centre	Sales processes
Profit centre (strict sense)	Profitability by the sale of services
Investment centre	Profitability including investments

Table 5: Types of profit centre and scope of responsibility

b) Implementation of the profit centre concept

Before a customer-oriented profit centre concept can be implemented in a financial services firm, a series of technical and organisational requirements must be met (Meyer, 1995, p.18ff). These include decentralisation of management structures, operational independence, allocation of costs and revenues to profit centres and creation of technical accounting units in accordance with the areas of responsibility. Control requirements also need to be taken into consideration. A three-dimensional scheme needs to be put in place to ensure that costs and revenues are appropriately allocated to the profit centre's customers, products and distribution channel. The *MFTP-concept* and *Activity-Based Costing/Process-oriented Standard Direct Cost accounting (ABC/PSDC)*-systems are the tools used to this end (see paragraph 1.C.II.2.a). Also, the profit centres must be run according to future-oriented guidelines in line with the objectives of the financial conglomerate as a whole. The PSDC system is one element for the implementation of the institutional control cycle used in this context.

c) Integrating lean and customer banking in profit centres

A financial conglomerate operating with the discussed structures and systems needs coordination and motivated staff. Vertical coordination concerns relations between the financial conglomerate's corporate centre and the individual profit centres. Horizontal coordination is concerned with relations between divisions. While profit orientation and organisational structure are of importance for the profit centre, the lean banking concept concentrates on the organisation of workflows and processes (see figures 6 and 7). There are notable cultural differences between these concepts. The profit centre concept is American. The individual and motivation are the key issues. Lean management on the other hand originated in Japan, and embraces the concepts of continuous improvement, customer-focused production and total quality management. In these latter concepts, the performance of the group as a whole is the most important issue (Voegelin, 1999, p.41). Aside from customer focus, there is a clear shift of focus to value creation processes.

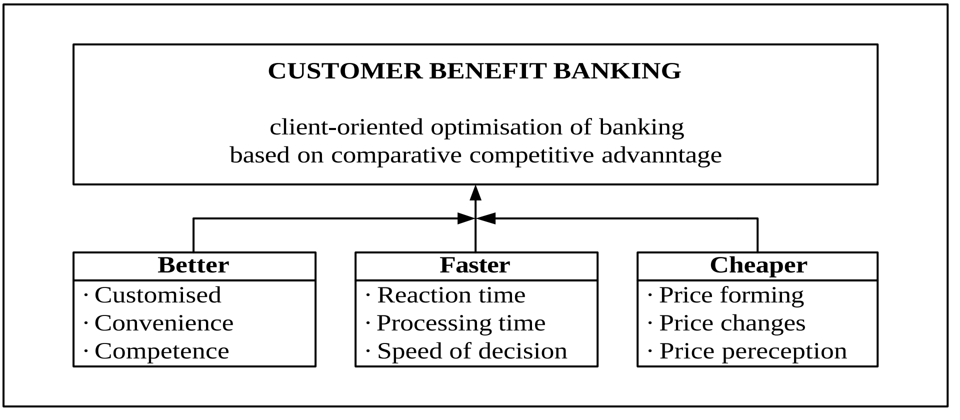

Figure 6: Customer benefit banking

The profit centre concept is complemented by process-oriented lean banking and creates a market-oriented organisational structure capable of rapid adaptation. As can be seen in Figure 8, the basic idea of business re-engineering[1], involving restructuring of the company in accordance with horizontal processes rather than functions, is thus realised within the profit centres (Voegelin, 1999, p.43). Value-oriented management based on a structure of this nature is thus realised.

[1] For an extensive discussion of business re-engineering see Hammer & Champy (1995).

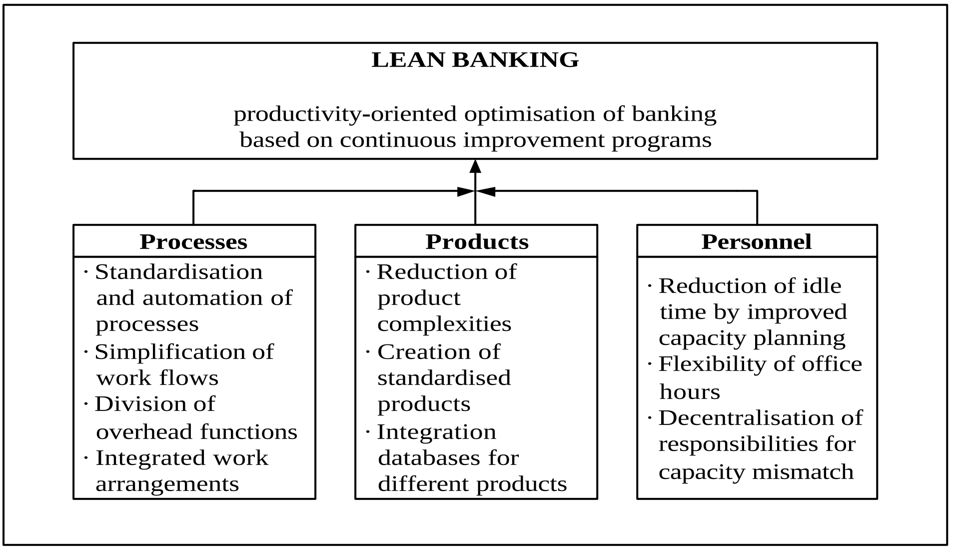

Figure 7: Lean banking

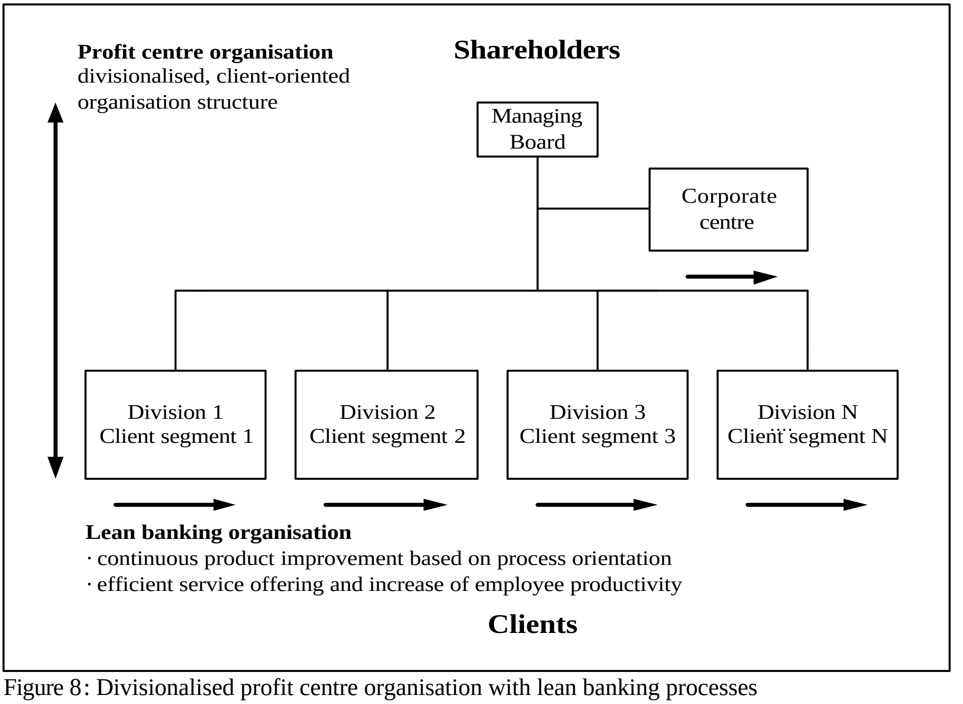

Figure 8: Divisionalised profit centre organisation with lean banking processes

II. Measuring value-based management

1. The importance of controlling

We have seen that *controlling* is central to a value-oriented business philosophy. Value-controlling, as part of value-based management, can be seen as a process with three steps: in the first step, the value of the firm is determined; in the second step, value controlling analyses the potential value creation of the firm; in the final step, business divisions are supported in the implementation of value enhancing strategies, which are based on value controlling, by controlling-specific measures (Lister, 2001, p.1127). A distinction can be drawn between strategic and operational controlling (Horváth, 1993, p.327). The responsibilities of strategic controlling can be to ensure the continued existence of the company (competitor analysis, strategy analysis, etc.), and to identify potential opportunities for successful new business. Operational controlling, by contrast, deals with the planning, management and control of operational processes. It does this based on the results of strategic planning, but can be a starting point for strategic controlling. Strategic and operational controlling are thus linked to each other in an interdependent relationship. Efficient controlling systems should meet the following requirements (Schierenbeck, 2000, p.15):

- Integration: integration into the corporate philosophy and policy has to be ensured, there has to a closed control loop between planning and controlling, and the controlling system has to be able to synchronise margin calculations with profit calculations
- Acceptance: if users are to accept the system, there has to be congruence between the relevant competencies, allocation and revenue responsibility, and the guarantee of the quality and plausibility of the information provided
- Flexibility to adapt: to changes in the organization, to developments in information technology, and to new calculations conditions
- Cost-benefit relationship: internal customer oriented functionality is more important than over-designed systems.

According to Vettiger (1996, p.37), the accounting system is an indispensable precondition for the efficient and effective operation of a controlling system: by providing operational and financial data, it supplies the information required for the controlling system to carry out its coordination and information function. It is particularly important that operational controlling and accounting are closely interlinked to take account of the fact that the accounting system – as the chief supplier of quantitative information – has to be an integral component of the controlling system. Controlling as an instrument of value-based management not only has to be linked closely with the divisions within the organisation, but also with the general financial services environment, in order for e.g. benchmarking against other financial institutions to become possible. Furthermore, controlling can use external data to work out strategies and to analyse the goals that have been achieved.

2. Instruments for value controlling

a) Matched Funds Transfer Pricing

All areas in a financial conglomerate, be they cost or profit generating, can be seen as creating or destroying value[1]. In recent years, the so-called *Matched Funds Transfer Pricing method* (MFTP) has established itself as the most suitable way of evaluating the relative advantages of the available choice of interest-earning transactions (Schierenbeck, 1997b, p.72ff); a core element in this method is the use of opportunity costs. The MFTP attempts to isolate the revenue contribution made by each individual transaction. Using the opportunity cost principle, the basic MFTP model attempts to evaluate each asset-side and liability-side transaction by comparing them individually to realistic alternative transactions – with comparable maturities – on the capital markets. As a rule, one always looks at alternative transactions on the same side of the balance sheet, i.e. an asset-side transaction (passive-side) is compared with an investment opportunity (borrowing opportunity) on the capital markets[2]. As a result, the gross interest rate, which is calculated across the institution as a whole, is split between the total asset-side and total liability-side conditional contributions on the one hand (i.e. the total additional returns of the individual transactions compared with alternative capital market transactions with equivalent maturities and currencies), and the structural contributions (additional returns based on maturity and currency transformations in the sense of a lending premium) on the other. In this way it is possible to produce an accurate allocation of revenue contributions to each individual reporting unit[3]. Use of the basic model is limited to fixed-interest business (e.g. final maturity loans without discounts, as well as term money) that permanently ties up capital over its lifetime[4]. It makes sense for a financial conglomerate to use the MFTP if it also analyses and manages balance-sheet business with the help of decision-oriented effective margins on

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[1] For a discussion of value controlling, we refer to Schierenbeck & Lister (2001).

[2] For exceptions see e.g. Schierenbeck (1995, p. 65ff). The corresponding customer interest rates are adjusted for risk, and the opportunity cost interest rates are adjusted to allow for regulations on minimum reserves and liquidity regulations. Fluctuating interest rates and split capital markets rates should be taken into account.

[3] As a rule, the conditional contributions are allocated to the customer areas, whereas the treasury department is allocated the structural contributions.

[4] In order to make the MFTP work for other individual transactions, it has to be supplemented by the cash value model (Wimmer, 1993, p.140ff), the main feature of which is the (dynamic) calculation and periodic distribution of conditional and structural contributions on the basis of the interest rates that can actually be achieved in the capital markets and in customer business.

the basis of individual transactions[1]. The MFTP-concept also has limits as an aid to decision making, and various elements have to be examined more closely. The MFTP-method is dependent on the efficiency of the capital markets[2]. For banking transactions with no capital markets equivalents, the maturities and/or interest rate assumptions used can only be approximate (Meyer, 1994, p.626). The MFTP-method does not automatically co-ordinate asset and liability positions, which means that bank-wide balance-structure management might be necessary. If market interest rates are used, no account is taken of the systematic characteristics of bank deposits and loans with regard to the maturities and volumes of equivalent, but not intermediated, financings (Neus, 1997, p.45). At the time when the transaction is concluded with the customer who is being advised by the bank's front office department, central management has no influence on the size of the structural contribution (Wimmer, 1993, p.130). Despite the criticism, the MFTP concept has established itself above all other modern interest rate transfer concepts. It thus has to be included in an integrated management approach, especially if the financial conglomerate concerned is supposed to be managed using the profit centre concept. In its expanded calculation form, the MFTP is a prerequisite, if the financial conglomerate wants to calculate the revenue contribution of each individual product, customer or region and attribute this contribution accurately and fairly to the relevant profit centre. Properly attributed revenues are used as the basis for various evaluations when calculating the profitability of customers, products and branches.

b) Activity-Based Costing

The value creation process within financial conglomerates has fundamentally changed in recent years. The individual areas of value creation within these firms have become much more complicated and interlinked, and this has led to an increase in joint costs as a proportion of overall costs (Voegelin, 1999, p.26). Automation and rationalization in particular have encouraged this trend. Traditional cost accounting systems, which tend to use overhead allocation and fixed cost proportionalisation in cost centre accounting, take insufficient account of the changed relationship between individual and joint costs[3.] In cost management three trends can be distinguished (Shuh, 1997, p.35ff): 1) the functional expansion of cost accounting, which has given more weight to process design, 2) the temporal expansion – in that cost accounting is now used not only as an accounting method, but also as a forecasting tool, and 3) the integration of systems for cost planning, cost control and cost management. As the objects of costing are always

[1] Over recent years the *treasury effective interest rate method* (TEI)[1] is found to be an appropriate method for this purpose (Schierenbeck, 1997b, p.163ff). This is an applied method of classic dynamic investment calculation, which calculates interest rate capitalization by focusing over time on opportunity cost transactions and transferring these to customer transactions. Account is taken of the fact that interest also has to be paid on immature trenches of investment when refinancing transactions (Schierenbeck, 1995, p.105).
[2] Main inefficiencies are: volume restrictions, outside influence, limited access and split capital market rates.
[3] For a criticism of the traditional systems see e.g. Bohnenkamp (1995).

activities, *activity-based costing* (ABC) tries to avoid the risk of miscalculation and erroneous decisions by focusing on value creation processes and on production activities. The main difference between activity based costing and traditional cost accounting[1] is the differentiated analysis and allocation of overhead costs, which allows an accurate division of (overhead) costs to the individual products and services that actually generate these costs. ABC can deliver additional information, the impact of which can be divided into three effects (Coenenberg, 1993, p.209ff): the allocation of overhead costs on the basis of the actual use of operational resources to produce services leads to a different cost charging than when done by the traditional systems; in addition, ABC offers the opportunity to accurately and fairly reflect the complexity and variety of services and products; with traditional full-cost accounting, a constant overhead rate per unit is charged on the basis of proportional overhead cost allocation; however, process costs per unit decrease as the number of units increases: ABC takes this into account. ABC can provide in a powerful evaluation capability in terms of actual product costs, capacity utilisation, and period analysis (Meyer, 1995, p.32ff).

The degree of complexity of the ABC-system will be influenced by the pursued corporate goals, if there is only one goal, a small number of cost drivers will suffice, and by the variety of products, e.g. the degree of similarity between the different products/services in the range (Cooper, 1990). ABC can be used to investigate the profitability of market areas, customer segments and individual customers, which allows for analysis of the influence of changing demand on overhead costs. The concept of ABC is characterised by a two-step approach, in which two different types of cost driver are used (Cooper & Kaplan, 1988, Innes & Mitchell, 1993, p.59). In the first step, actions serving to produce a particular service are brought together as activities. To have a sound foundation, a labour and resources analysis is necessary. This means that work processes must be clear and used resources must be allocated to (parts of) activities[2]. This will lead to insights on where costs really are and allows for comparison to the (monetary or non-monetary) value brought by that activity. Cost drivers, factors, which reflect the volume of work throughput of the activity, can then be identified. If there are

[1] In traditional accounting systems direct costs are added to indirect overhead cost based on a percentage, thus falling in a cost pool, which is difficult to divide correctly.
[2] In order to come to this labour analysis, Cole (1995, p.43ff) distinguishes between several approaches:

- Historical averaging: this is used when the one wishes to avoid disturbing the workers at their stations or when there is a only a need for information based on historical relationships; it involves comparing relationships of previously recorded data in order to draw inferences on the measurements of tasks
- Self-logging or time ladders: this method relies on the workers to account for their individual time
- Relative values: here task or activity values are assigned by relative weight to one another; usually the lowest time is assigned a weight of 1.0; the weights are determined through a one-time analysis
- Work sampling: this is the process of surveying the distribution of work through a form of sampling, such as randomly spaced visits; this is most useful in sorting out multiple task times in a work unit
- Stopwatch: standard times may be developed as sample observations are made and tasks are timed
- Predetermined time standards: these are defined as the arrangement and classification of movements with the assignment of associated time values.

more cost drivers in one cost pool, further analysis is needed on segregating cost drivers. The activities are allocated to the corresponding cost pool on the basis of a cost driver; there is one for each activity; the allocation is made either by measuring the proportion of resources used directly, or by estimating resource use indirectly. The greater the number of actions that are put together under one activity, the more difficult it becomes to evaluate the corresponding use of resources with only one cost driver[1]. According to Innes & Mitchell (1993, p.66) three types of cost driver have emerged: 1) pure activity output volume: this can occur where the basic transactions of the activity are identical in terms of their resource demands, 2) activity/output volume/complexity: this can occur where the basic transactions of the activity differs in terms of their resource demands, 3) situational: this basis can be used where an underlying situational factor can be identified as the key factor determining the workload of the activity. In the second step, the activity costs are allocated to the relevant products (Cooper, 1990, p.345ff). The choice of cost driver is critical here, because the allocation should take place in accordance with the actual use of resources. Figure 9 (based on Cooper, 1990) explains this. For the purposes of evaluation and analysis, some individual activities within a service production process, or the corresponding cost pool, can be grouped together in what is known as an activity centre. By allocating the right activities to the right hierarchical level within the production process, the attribution of costs can be made even more accurate (Cooper & Kaplan, 1991, p.131ff).

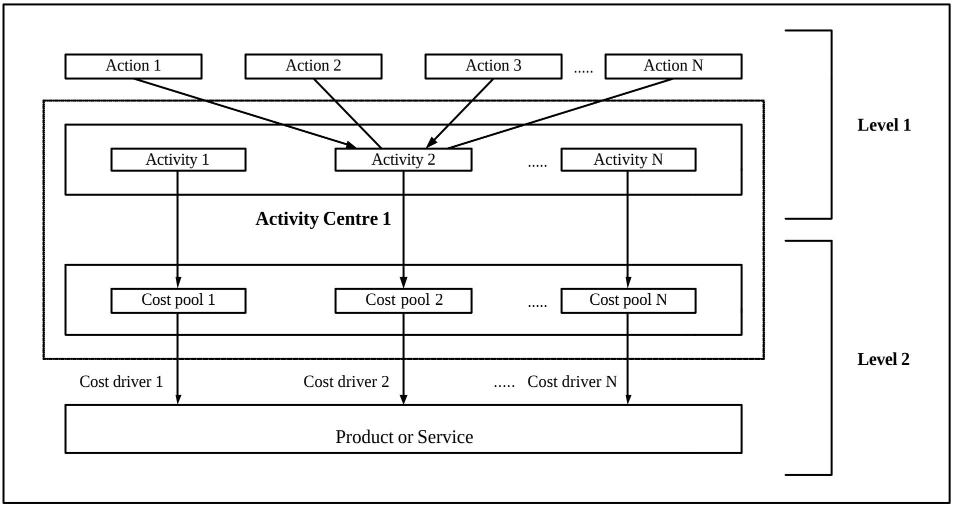

Figure 9: Activity Based Costing scheme

[1] Putting various actions together as *activities* makes the costs shown for each product less precise, though at the same time this method dramatically reduces the work required (Cooper, 1992, p.361ff).

c) Process-oriented Standard Direct Cost Accounting

In general, management is based on both present and future considerations. Full cost accounting systems such as ABC are not suitable for planning and short-term steering purposes in financial conglomerates, as they are based on historical data. The use of planned or standard costs within a future oriented system is thus essential. It is in this context that the concept of process-oriented standard direct cost accounting (PSDC) arises (Bohnenkamp, 1995). Through the derivation of specific budget values for activities, it is particularly useful for the implementation of planning and budgeting on a cost-driver basis. The primary objective of PSDC is to gather and quantify all business processes of the financial conglomerate for cost accounting purposes. These business processes are to be understood as a bundle of activities carried out in relation to the production or sale of financial products and involving more than one cost centre (Schierenbeck, 1997b, p.328ff). A PSDC-system has the following characteristics:

- The principle of direct cost accounting with standardised units of service production makes it possible to establish a hierarchical system for step-by-step (direct) cost allocation
- Calculation of cost items per unit of output on the basis of standard workflows, processing times and volume of resources used; and definition of standard cost absorption rates on the basis of these quantities
- Relativisation of individual and general costs considerations and assignment of primary production processes to the lowest possible hierarchical levels or to the relevant dimensions (customer, product, sales outlet). The process costs are thus allocated to each unit of service production on the basis of their origin. This permits allocation even without allocation keys.

In order to apply a system of this nature, it is necessary to plan future production of services (production processes, volumes, costs and revenues) in detail. The use of standard costs provides clear criteria for the calculation of future output. Thus, identification of standard costs is a prerequisite for an internal billing system. The comparison of target costs with actual costs calculated at the end of the relevant planning period also provides significant data for meaningful profitability analysis. Before a PSDC system can be implemented, it is necessary to analyse and clarify in detail certain issues arising in the context of the origin of costs. Which cost categories are incurred in the production of services at what hierarchical levels of the bank, and what are the cost drivers. This analysis results in a three-way split of the costs incurred (Schierenbeck, 1997b, p.331ff):

- Direct standard (process) costs: these costs arise in the context of recurring processes. They can be allocated to production processes at the relevant hierarchical level of the financial conglomerate as direct (process) costs[1]
- Indirect standard costs (overhead): These comprise areas of activity, which are not attributable even at the highest level of the cost hierarchy and therefore cannot be allocated either to the direct operational service production process or to projects. The output generated by these activities cannot be standardised. Accordingly, the PSDC system is only partially applicable in this area and conventional cost accounting classifications must be used[2]
- Residual costs: these arise from the non- or inefficient use of existing capacity or from increases in cost levels. As they cannot be allocated to a specific source, these costs have to be treated as overhead costs.

The main areas for the application of PSDC as a hierarchically structured variable cost accounting system are the identification of standard cost items and thus for the calculation of customer, product and business costs. The standard costs worked out in this manner are also suitable for use in the institutional control cycle as a planning, budgeting and control tool. According to Schüller (2001, p.304ff), the PSDC system can be applied to the following: performance benchmark for business results, productivity efficiency benchmark, and determination of price of services billed internally. A critical approach to the way activities are defined is important here, as the definitions themselves may have a decisive influence on the accuracy of the system[3]. ABC makes use of the cost driver principle as the basis for the categorisation of all types of costs, as opposed to (process) cost centres. This principle, however, becomes ever more difficult to apply as the costs become further removed from the main business activities and it becomes less easy to establish a direct relationship between costs and output. In these areas, the application of process-oriented cost accounting is no different from "classical" cost accounting with regards to quality of allocation. Particularly in the financial services industry, the implementation of ABC can be restricted. The main argument for this is the (supposedly) large number of non-repetitive activities carried out in the production of services. The costs incurred cannot be accurately allocated to cost drivers, and this can have significant effects as their number increases. Nevertheless, it may also be argued that the extent to which an activity is regarded as repetitive depends primarily on how it is defined. The more precise the definition, the less activities are considered repetitive. However, if a wider definition is used more activities can be appropriately

[1] Schierenbeck (1997, p.335) shows a classification of relevant cost items as a core part of the PSDC system.
[2] These overheads are estimated to represent from 5 to 15% of the total costs of banks (Schierenbeck, 1997, p.333). The system becomes a full cost system where these amounts are included in the calculation.
[3] According to Vettiger (1996, p.174), the costs and time required to implement process-oriented systems should not be underestimated. In particular, the increasingly dynamic environment (as mentioned earlier) in which financial conglomerates operate raises the issue of system design. The system must be quickly adaptable to changes in the organisational structure.

traced and allocated to services and cost drivers. Because the majority of general costs are short or medium-term items (e.g. personnel costs and fixed asset costs), ABC or PSDC provides only a minimum of useful management data for product and pricing policy decisions (Voegelin, 1999, p.36). Indeed the danger exists that using full costs as a basis for negotiating terms and conditions with customers can result in inflexible positions. In certain circumstances, this might lead an institution to price itself out of the market. These costing methods are thus not valuable as a basis for short-term decisions, but rather for tackling long-term issues. Combining these systems, ABC serves as a strategic planning and control tool, and PSDC serves for operational control purposes.

3. The financial dimension balanced

a) Introduction to the Balanced Scorecard

The balanced scorecard is a tool, which can be used to translate strategy, be it on corporate or on a divisional level, into specific strategic objectives (Kaplan & Norton, 1996, p.10). It is called *balanced* as financial measures, discussing past performance are complemented by non-financial measures of future performance. It is important to note that in using the balanced scorecard in financial services firms the financial measures must be risk-adjusted; we arrive then at a *Risk Adjusted Balanced Scorecard* (Schierenbeck & Lister, 2001, p.52). The balanced scorecard takes on the following views (as shown in Figure 10):

- Financial perspective: appropriate financial metrics should be developed; to succeed financially, how should we appear to our shareholders?
- Customer perspective: to achieve, how should we appear to our clients?
- Internal business process perspective: the most critical processes for achieving customer and shareholder objectives are identified. The question: to satisfy our shareholders and customers, what business processes must we excel at?
- Organisational learning and growth perspective: to provide the infrastructure to enable objectives in the other three perspectives to be achieved. To achieve our vision, how will we sustain our ability to change and improve? Three principal categories for exploration are: 1) employee capabilities, 2) information systems capabilities, and 3) motivation, empowerment and alignment.

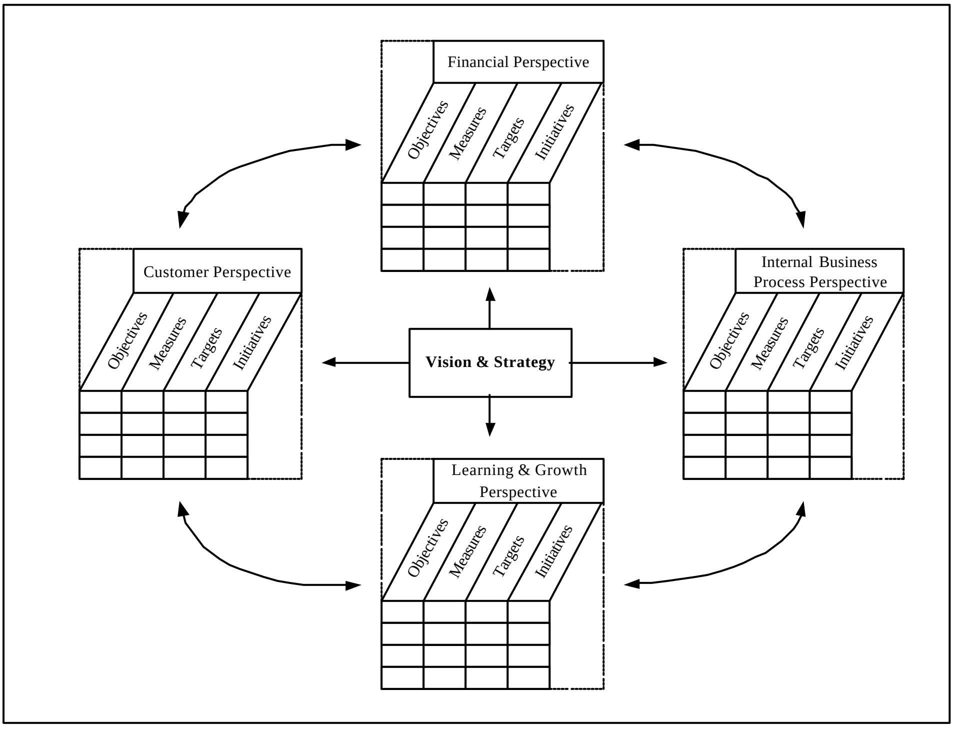

Figure 10: Balanced scorecard

b) Workings of the Balanced Scorecard

The balanced scorecard can be seen as a system of ratios, which are connected to each other via cause-and-effect relationships (Wiedemann, 2001, p.495ff), supported by the controlling function. These relationships show the effect of the change in ratios on other ratios and final value. In this way, implementation of strategies can be assessed. By choosing ratios, a balance should be struck between objective and subjective ratios, external and internal oriented ratios, and ratios which describe the past and the future. At the end of the cause-and-effect relationships stands the financial result. The balanced scorecard does improve the link between business planning and budgeting.

c) Implementation of the Balanced Scorecard

Implementation of the Balanced Scorecard is done in four steps (Schierenbeck & Lister, 2001, p.51ff): 1) formulation of vision, strategy and corporate goals, 2) communication of results of step 1, which allows for incentive systems to be aligned, 3) planning of goals for parts of the organisations, and 4) control of the realisation of goals [1,2,3].

III. Focus on risk management

1. The core of risk management

a) Introduction to the concept of risk

The last of the tools for value-based banking concerns the risks arising from financial conglomerate's activities. Financial conglomerates accept risks in order to generate profits (profit-oriented risk policy). The acceptance of risk is therefore subject to profitability concerns on the one hand, while on the other, the financial conglomerate's ability to carry risks must be taken into account as a strict condition on activities. From among the many systematic risk typologies, five main risk categories are of importance to financial conglomerates (Schierenbeck, 1997c, Zimmermann et al, 1995):

- Operational risks: these are often termed "people risks" and are defined as risks that could arise for the financial services firm as a consequence of voluntary or involuntary errors or inappropriate action on the part of staff
- Systemic risk: this concept embraces hazards affecting the stability of the financial system as a whole or raising the spectre of a general breakdown
- Strategic risks: these are risks related to (erroneous) decisions made by management of the financial conglomerate in relation with products, acquisitions, investments, et cetera
- Credit and counterparty risk: these are risks arising as a consequence of impairments in the solvency of debtors. These risks are not only significant in "traditional" lending but also in relation with derivative business
- Market risk: this concept includes the risk of losses arising in the positions taken by the financial conglomerate due to changes in market prices; the main market risks are interest rate, currency and share price risks

These types of risk are not unrelated, but rather interact which each other. That is to say, they affect each mutually and can have both cumulative effects as well as cancelling

[1] A difficulty looms as it might prove difficult to translate vision into concrete actions, certainly when supporting systems and processes are not synchronised to relate to these corporate actions and when too much focus is put on single budgets.
[2] The scorecard is not only useful on a corporate level but can be decentralised to the smallest organisational unit; the budget is the closing part of the scorecard and is essential for success.
[3] Strategic feedback and learning should be used to test hypotheses and assumptions on which strategies are based; this can be achieved by analyses of ratio correlations (e.g. of different dimensions), scenarios based on real situations of the past, analyses of success stories, and peer review; this latter step is also useful as a system for the early recognition of opportunities and threats.

each other out. Compliance with the provisioning requirements established by the regulator is no longer sufficient to control these risks. Therefore, in the context of VBM the following definition for risk control applies: the task of risk control is to identify, record and assess (particularly with regards to interrelationships) the individual banking risks arising at different aggregate business levels, and to influence and manage them within the framework of VBM (Voegelin, 1999, p.44).

b) The risk matrix as a tool for risk management

In order for risks to become tangible, Schierenbeck (1997c, p.9) shows a risk matrix forming the core of a risk control system (see Figure 11). The risk matrix is formed by the risk categories affecting the individual areas of the business, as structured in terms of products, regions and customers, and the organisational structure. It may be the case that individual risk positions involve more than one risk category[1]. Using this risk matrix structure, management gets to know on what risks the financial services firm entered, how high they are, what their structure is and where they are located.

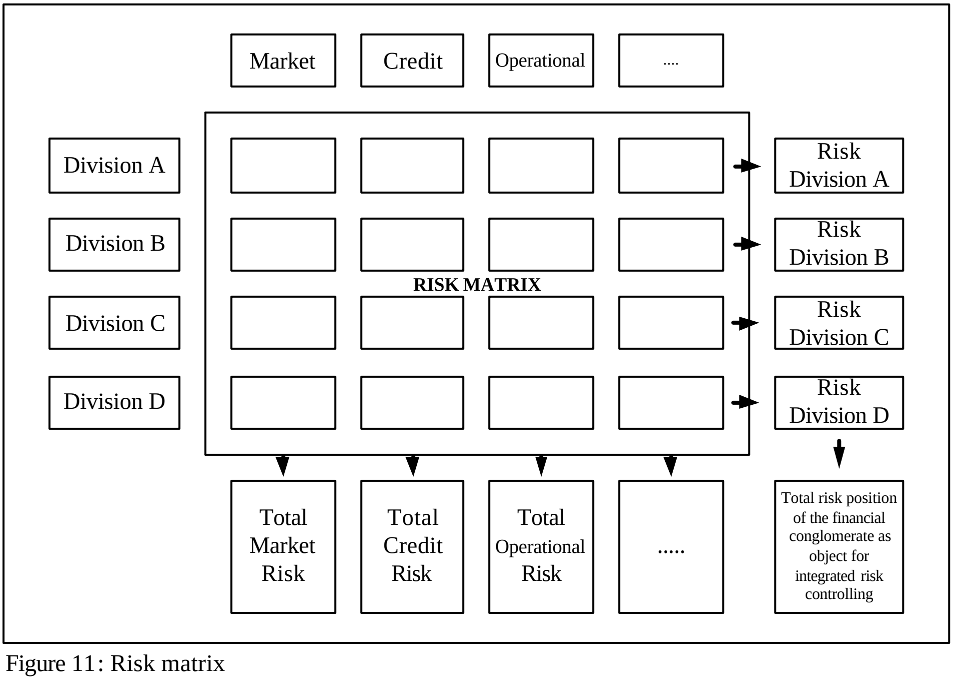

Figure 11: Risk matrix

[1] E.g. derivatives positions contain various market and counterparty risks, while variable interest-bearing securities are subject to the risk of non-performance and interest rate risks.

c) Asset and liability management, and market and credit risk

In *Asset & Liability Management* (ALM) a common aim in terms of VBM is the allocation of internal (risk) capital to the organisational units and activities of the financial conglomerate in accordance with economic criteria [1]. This enables establishing the extent to which the market value of own resources invested by the financial conglomerate may fluctuate in response to changes in prevailing market conditions. In turn, this means that the risks inherent in individual financial activities or the positions taken must be identified and assessed. The concept of *value at risk* (VaR) is nowadays widely used in the financial services industry to ascertain and value the risks inherent in financial positions (i.e. market risk); the actual applied formulations can differ markedly though. In general, the VaR is treated as a measure of the maximum possible change in the value of a portfolio of financial instruments within a given likelihood and for a specified period and is intended to quantify the potential losses inherent in a portfolio within a given likelihood and for a specified period of time. The underlying VaR concept[2] is based on the following Equation 4 (Paul, 2001, p.156):

$$\begin{aligned}
&\mathbf{VaR} \\
&= \mathbf{MarketValue\ of\ Positions * Sensitivity\ of\ Positions\ to\ Changes\ in\ Underlying} \\
&\quad \mathbf{Factors * Potential\ Change\ in\ Underlying\ Factors} \\
&= \mathbf{Pos_{market\ value} * S_f * ?f}
\end{aligned}$$

Equation 4: General formula for Value at Risk

The applicability of VaR is based on a number of assumptions. The chief factor is the use of historical data and the simplified approach of basing standard distribution on historical distribution when setting parameters for calculating future market trends[3][4]. VaR recommends itself as a highly practical risk assessment tool, because it enables the financial conglomerate management to consider all transactions and positions (whether

[1] For an extensive and recent discussion we refer to Paul (2001).
[2] Also in the field of ALM
[3] As a first step, the market values (or appropriate equivalents) of the various assets, liabilities and off-balance-sheet positions must be determined. The main information regarding balance sheet positions is provided by the MFTP concept. The volatility of the positions is then calculated on the basis of historical data (e.g. in the form of variances). The results for these two blocks of data are then applied as multipliers to the expected market fluctuations (scenario simulation: e.g. variance/co-variance method, Monte Carlo simulation, benchmark scenarios, etc.) at differing levels of confidence. Finally, the financial conglomerate's overall risk position is calculated as the sum of the individual positions. In the course of this process, however, the individual interdependences of risks or the expression thereof in the individual positions taken by the bank must be taken into consideration. This is done using the correlations between the individual positions identified, which is expressed as the diversification effect and has the result that the overall risk position of the bank is in fact smaller than the sum of the individual exposures (for a detailed discussion of the diversification effect, see Elton & Gruber, 1995).
[4] For further discussion of the VaR-concept we refer to Jorion (1997).

on or off the balance sheet) using a single measurement procedure and to quantify the overall risk of the institution using simulations, while taking the diversification effect into consideration. The quantification of the VaR makes it possible to set aside the necessary funds (risk provisions) to cover risks in accordance with criteria set in terms of the desired safety margins (level of confidence). Moreover, these techniques also make it possible to calculate the likelihood that risk provisions will need to be applied. Credit risk, at a minimum, is the risk of loss due to borrower defaults and is attributed to all units with borrower or counterparty exposure (Zaik et al, 1999, p.325). It occurs across the entire spectrum of financial institution's activities and includes loans, debt securities, equity investments, on- and off-balance sheet counterparty exposures etc. Issues of concern in credit risk management include (McLoy & Lee, 1999, p.84): 1) structure of the balance sheet, including relative proportion in different low credit-risk assets compared with higher risk assets, 2) breakdown of fixed-income securities by type, largest positions, market value and maturity, 3) breakdown of equity securities by economic sector, largest exposures, proportion of investment portfolio relating to previous underwriting positions, investment strategy, and book value compared to market value, 4) credit portfolio broken down by maturity, loan type, collateral, customer base, economic sector, size, currency and country, 5) strategic stakes in companies and types of benefits and risks posed by these holdings, and 6) extent to which political or other interests are able to influence decision making. Credit risk management has evolved from credit scoring of individual borrows to sophisticated aggregate models of borrowers' default probabilities and the extent of asset recovery (Marshall, 2001, p.24). The measurement of credit risk requires estimates of expected loss, unexpected loss, and unexpected loss contribution. The capital level is calculated based on the unexpected loss contribution and the coverage level desired[1].

2. Understanding operational risk

a) Definition of operational risk

Although there can be many definitions for operational risk, we use the following definition: *operational risk* is the potential for any disruption in the financial conglomerate's (operational) processes; operational risk can also be seen as a quantitative residual, i.e. the variance in net earnings not explained by financial risks

[1] The first step is to calculate expected loss, the average losses anticipated from a given credit exposure measured on a per annum basis. For individual credits, expected loss is modelled and computed as the product of, at a minimum, three variables: default probability, loan equivalency exposure, and severity (Zaik et al, 1999, p.327). Applications of using VaR and taking account of diversification, i.e. adding a loan to a loan portfolio (for a discussion on credit risks in a loan portfolio, we refer to Saunders, 1997), handling unexpected losses and credit limits, are CreditMetrics, developed by JP Morgan, Credit Portfolio View developed by McKinsey, and Credit Risk+, developed by Credit Suisse Financial Products.

such as market and credit risks (Marshall, 2001, p.25ff)[1] and includes reputational risk, legal enforcement of contracts and claims, leading to long-term damage to the financial services firm's standing[2].

b) Causes of operational risk

According to Donahoe (1998, p.99ff) underlying causes of operational risk include complacency or a false sense of security, cost, as controlling operational risk can be seen as a new activity, difficulties in measuring operational risk, miscommunication when using jargon, over-reliance on outside vendors and suppliers, incompatible systems, decentralisation which complicates oversight of operational risks, and organisation-specific factors. Chorafas (2001, p.16ff) states that operational risks are primarily caused by mismanagement, lacking quality of skills and organisational flaws; Figure 12 shows this. Reputational risk[3] can result from incomplete or false information (Sheldon Green, 1992, p.10) and internal problems, particularly mismanagement, inadequate preparation or flawed business plans (Chorafas, 2001, p.34).

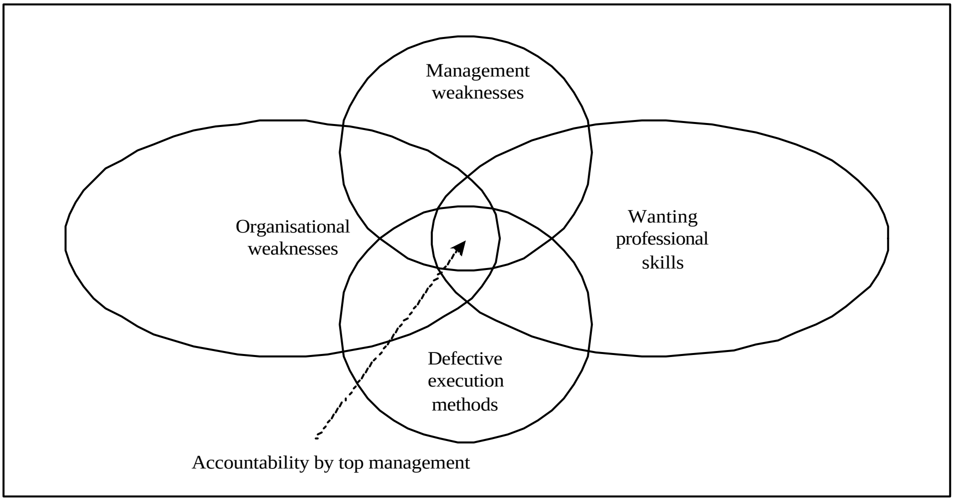

Figure 12: The four key domains of operational risk

[1] For a practitioners guide on operational risk, we refer to Arthur Andersen (1998).
[2] An example is Barclays Bank, which was left with a serious image problem after a series of public relations blunders and badly timed announcements in 1999 and 2000. Barclays is now examining how it can better integrate reputational risk into the risk management function (Aldred, 2000, p.68ff).
[3] Taking in to account that, generally speaking, physical assets now represent less than 25 percent of a company's net worth, down from 75 percent in 1991, minimising reputational risk has outstripped the management of physical risks as the chief concern of UK risk managers (Unsworth, 2001, p.53).

c) Impact of operational risk

To show what operational risk can encompass, Table 6 shows some examples. It is clear that financial conglomerates should have a philosophy and toolset to deal with operational risks pre-emptively.

Institution	**Activity**	**Year**	**Loss US$ mio**
Daiwa Bank	Unauthorised bond trading	1984 - 1995	1,100
Sumitomo Corp	Unauthorised copper trading, fraud, and forgery	1986 - 1996	1,700
UK life-insurance industry	Pensions mis-selling and non-compliance	1988 - 1994	18,000
Credit Lyonnais	Poor lending control	1980s, 1990s	29,000
Kidder Peabody	Bond trading, lack of internal controls	1994	200
Morgan Grenfell	Misrepresentation	1990s	640
Barings	Inadequate control of futures trading	1995	1,600
Deutsche Bank (Grenfell)	Investment outside authority	1996	600

Table 6: Examples and impact of operational risks

Risk tends to decrease value by limiting management's ability to achieve its objectives. Risk management tries to limit this reduction, thereby increasing value, and must be organised to facilitate the objectives as show in Table 7 (Marshall, 2001, p.48).

Operational objectives	**Business objectives**	**Risk components**	**Rationale**
Efficiency	Cost reduction	Expected losses	Lower costs
Change management	Growth	Unexpected losses	Ease of planning; less use of external financing
Internal control	Efficient use of capital	Catastrophic losses	Decreased likelihood of financial distress; satisfying regulatory requirements
Opportunism	Revenue increase	Upside potential	Typically strategic options provided by infrastructure investments

Table 7: Integration of objectives for operational risk management

3. Management of operational risk

a) The sense of operational risk management

Operational risk management finds its greatest use in preventing loss of expected cash flows, rather than reducing the discount rate for those cash flows (Marshall, 2001, p.50ff). Discount rates reflect only those risks that are non-diversifiable. If losses cannot be controlled internally, the risks can be transferred externally. However, investors can nearly always replicate risk transfer directly. This suggests that risk transfer of uncontrollable risks has little or no effect on the discount rate. In contrast, most controllable losses affected by loss prevention and loss mitigation activities are firm specific and therefore not correlated with other firms' losses. These losses can be diversified away by shareholders; therefore, loss control activities too have limited effect on a firm's cost of capital. To conclude, the only operational risks that have an effect on the discount rate are those for partially controllable risks for which the only other strategy is decreased business levels or business exit. As a result of this activity, operational risk management will increasingly influence (the perception of) shareholder value creation vis-à-vis risk exposure (Laycock, 1998, p.131). Table 8 shows some examples of risk factors (Marshall, 2001, p.85).

Controllable	**Partial controllable**	**Uncontrollable**
Product development	Operating leverage[1]	Market volatility
Processing speed	Loss of key staff	Economic performance
Number and variety of distribution channels	Product complexity	Competitive position
Volume and diversity of business	Infrastructure development	Regulation
Risk policies	Operation size	Customer demand
Process errors	Level of automated processing	Natural disasters
Quality of customer service		Power outages

Table 8: Examples of risk factors

Managing expected losses is the easiest to justify since these directly affect the profitability, and hence the value of the firm to shareholders. Subtler is the management of variance, or unexpected losses. Usually, most managers are naturally averse to outcome variance. But financial conglomerates are ambivalent. On the one hand, these

[1] To what extent revenue fluctuations match expense fluctuations, depending on the asset base relative to operating expense.

firms are in the business of taking on and managing risks. It is only through such risks that firms can obtain their required returns. On the other hand, there are good reasons for stakeholders to fear variance in outcomes. Shareholders can hold diversified portfolios that remove much of the non-systematic risk faced by firms. Marshall (2001, p.49ff) notes that, portfolio diversification by shareholders and firm risk management are naturally such close substitutes that it makes sense to ask which has the lower cost. The marginal cost of diversification through the stock market is very low compared with risk management. So, the extent to which we should involve ourselves in risk management diminishes with the ability of shareholders to reduce risk on their own. Nonetheless, risk management of both those risks that managers can control through prevention and mitigation and those that they cannot control directly (only through risk transfer and financing) can still add value to shareholders. For controllable risks, risk management is assumed to be a competitive necessity. Firms have different reasons to manage the uncontrollable portion of their unexpected losses and risks: 1) business planning of financing and investments is made easier without fears of uncontrollable risks, 2) for firms facing convex tax schedules[1], minimizing variance in the firm's pre-tax income decreases tax payments, 3) risk management may reduce the expected costs of financing losses because external funding activities are more expensive than internal funding activities by better aligning investment sources of internal capital with projected uses of capital, 4) risk management might change the level of systematic risk by positioning the financial conglomerate's risk profile to be more in keeping with investor demands, 5) risk management reduces the likelihood of financial distress, 5) risk management allows the increased use of debt financing, which in turn creates interest tax shields, supporting shareholder value creation, and 6) regulators may require certain levels of risk management through particular risk-based capital levels, which can be used to justify managing catastrophic losses.

b) Guidelines for operational risk management

As we have seen in paragraph 1.A.I.1.c, much of the impetus for operational risk management has come from industry groups. We mention four types of qualitative guidelines (Marshall, 2001, p.35). *Industry guidelines* for good operations practices in the financial services industry: these include the separation of front-office from back-office operations, independent risk management reporting to senior management, periodic and effective audits, quality information systems, and risk integration across the firm; a major challenge remains the reliance on a variety of systems across a number of different business lines for valuation, processing, settlement, accounting, and risk management. *Guidelines for internal control*: on operational risk, already in 1992, the Committee of Sponsoring Organisations (COSO) of the Treadway Commission (COSO,

[1] I.e. an increasing marginal rate of taxation.

in: Marshall, 2001, p.37) issued a report focusing on internal control and corporate governance. It said that internal control must incorporate the following elements: process-based risk assessment: a set of techniques to identify, measure, analyse, and manage the risks related to various activities, sound control environment: the culture, values, and resources available within an organisation must be risk aware, robust control activities: carrying out policies and procedures to secure objectives, effective information and communication: systems to capture and exchange the information required for effective operations, and ongoing monitoring: the means to monitor operations to enable flexibility and responsiveness to changing conditions. *Process and resource quality guidelines*: quality management has become an important topic in financial services. One of its leading advocates, the International Standards Organization (ISO), has defined it as a management approach of an organisation centred on quality, based on the participation of all its members and aiming at long-term success through customer satisfaction, and benefits to all members of the organisation and to society (Juran, 1999). The ISO-standards require features that should be present in the management system; the requirements can be summarised as a control loop of effective goal-setting and resource allocation, implementation, maintenance and record keeping, performance assessment, and learning.

According to Marshall (2001, p.38), quantitative measures for operational risks are still not as advanced as those for market and credit risk. *Regulatory capital requirements*: it is precisely the drive toward regulatory capital requirements based on assessments of financial conglomerates' market and credit exposures that is prompting many operational risk assessments. While regulators have traditionally focused on audits and measuring certain ratios[1], they increasingly look to limit institutional guarantees and accurately estimate capital adequacy measures as a proxy for institutional solvency. The required level of risk capital is determined by the nature of the catastrophic risks associated with the various assets, liabilities, and operations of the financial conglomerate and the acceptable probability of insolvency[2]. Further, guiding principles for operational risk management are (Crouhy et al, 1998, p.51): objectivity: risk measures using standard criteria; consistency: same risk profiles result in same reported risk, relevance: reported risk is actionable, transparency and completeness: all material risks are identified, captured and reported, and group-wide approach: risk should be aggregated across entire organisation. Senior management may not fully understand the hidden risks involved in many new services. Operational risk is often managed on an ad hoc basis, and financial conglomerates can suffer from a lack of coordination among functions such as risk management, internal audit, and business management (Crouhy et

[1] Such as financial conglomerate' liquidity ratio of short-term assets to liabilities and interest margin.
[2] Marshall (2001, p.75) notes that after a major disaster 40 percent of organisations go out of business within one year; 43 percent never reopen, and 29 percent go under within two years.

al, 1998, p.47). Operational risk managers should actively investigate new products and service proposals for hidden risks. They should also lead the development of management and control solutions and policies to minimise unnecessary risk. A corporate operational risk model may create the false impression that the head of operational risk is responsible for managing operational risk throughout the financial conglomerate. Actually, operational risk originates at a micro level and should be managed on a decentralised basis (Aerts, 2001, p.55). Responsibilities for implementing guidelines for operational risk management can be distributed as shown in Table 9 (Chorafas, 2001, p.92).

Hierarchical level in the firm	**Main activities**
Senior management	Determines risk control goals Differentiates between major/minor events Sets limits to operational risk Takes top level corrective action
Central operational control	Follows up on goals and limits Analyses the causes of operational risks Records and reports deviations Takes command and control level corrective action
Decentral operational control	Assures compliance with senior management directives Keeps accurate, detailed record of major operational risks Treats statistically minor operational risks Takes local level corrective action

Table 9: Responsibilities for operational risk control

c) Operational risk factors

Quantities influencing and determining operational risk are called operational risk factors. Risk factors can be specified by three elements (Marshall, 2001, p.65): 1) the factor's probability during a defined time period, 2) the factor's direct impacts on the target variables such as cash flows, net come or asset values, and 3) the factor's indirect impact on the frequency or mean impact of loss events during some time period. For financial conglomerates the factors as show in Table 10 are regarded as most important (Marshall, 2001, p.314). It is striking that operational risk seems to be more of a management task than an accounting task. Indeed, an overemphasis on the quantitative measurement of operational risks may be dangerous to firms without good management and staff or well-designed processes because it may lull them into a false sense of security and lead to unnecessary risk taking. Ultimately, the main defence against operational risks must be governance: management and staff who are knowledgeable about the risks and the good processes and systems that embody that knowledge.

Type of risk factor	**Risk factor**	**Risk management approach**
Design and complexity factors	Organisation Technology, products and processes Divergent goals and constituencies	Organisational design Reengineering Alignment of activities
Individual behaviour factors	Competence Honesty Motivation	Selection, training Culture, personnel selection, incentive system, fraud detection, shift rotation, boundary systems Culture, boundary systems, incentives, warnings
Cultural factors	Organisational culture and administration Leadership Morale and communication	Culture, aligned incentives, boundary systems, audit, policies Change in leadership, training, personnel selection Work and job restructuring, job enlargement, communication processes and tools
Change and volatility factors	Industry/environment Organisation/operations Technology	Business and market intelligence, organisational learning and knowledge management Project risk management, change management Redundant design, modularity and flexible open systems
Economic and financial factors	Revenue sensitivity Operating leverage Financial leverage Transaction exposures	Diversification Contractual risk transfer Financial restructuring Derivates for hedging

Table 10: Risk factors and risk management approaches

PART 2: DISCUSSION OF THE CORPORATE CENTRE

In this chapter, we will discuss the main governance body of the financial conglomerate: the corporate centre. Not only will we discuss central themes such as (de-) centralisation, coordination, and influence, we will also touch upon roles, functions, contribution, staffing, managerial issues and economics of the corporate centre. In assessing the effectiveness of the corporate centre, Campbell & Goold (1998) made a distinction in terms of management style, which will be dealt with in paragraph 2.B.II.1, but which does relate to topics in paragraph 2.A. The literature is quite dispersed and we try to reach a comprehensive overview in which we try to recognise patterns in theories. Further, together with part 1, it will from the basis for the integrated corporate centre concept for financial conglomerates, as presented in part 3.

A. The nature of the corporate centre

I. Decentralisation, coordination and influence

1. Decentralisation characterised

a) Characteristics of decentralisation

In the literature, and also in practice, quite some attention is given to the subject of decentralisation and centralisation. As we discuss corporate level management, we will limit the discussion to decision making. As decentralisation and centralisation are complementary concepts, we will often talk about decentralisation, thereby also implying effects on centralisation. In his comprehensive study, Bassen (1998) suggests to look at decentralisation using three characteristics (Bassen, 1998, p.31):

- Content: distribution of the decision competence and activities in the firm
- Direction: here we can distinguish between the vertical decentralisation where part of a decision or an activity is being performed on a lower hierarchical level, and the horizontal decentralisation where focus is placed on functions, markets, products etc.
- Dynamic perspectives: here we can distinguish between a static perspective where a decentralisation is fixed in an organisation, and a dynamic perspective where decentralisation changes on a continuous basis.

These characteristics will come back when we discuss models for decentralisation of decision-making.

b) Goals of decentralisation

In decentralisation of decision making the following goals are recognised (Bassen, 1998, p.47ff): flexibility for the divisions, increased transparency within the group, increasing innovativeness of the divisions, increase of the motivation of division managers, and ease of separating or integrating certain parts of the business. In pursuing these goals, autonomy costs arise, as the goal of integration, or acting as a group, is harder to reach. The causes for these costs are dependencies between divisions and the corporate centre. From Figure 13 (Bassen, 1998, p.53ff), it becomes clear that pursuing the goals of integration and autonomy at the same time produces a clash. When we choose to fully decentralise, we introduce opportunity costs as we miss out on the integration advantages, whereas when we choose to fully centralise we miss out on the autonomy advantages and introduce opportunity costs on that side. Therefore, any (part of) corporate centre should consider where it needs to be positioned on that continuum; this should not necessarily be in the middle. The level of influence the (part of the) corporate centre has to assume, determines the position on this continuum.

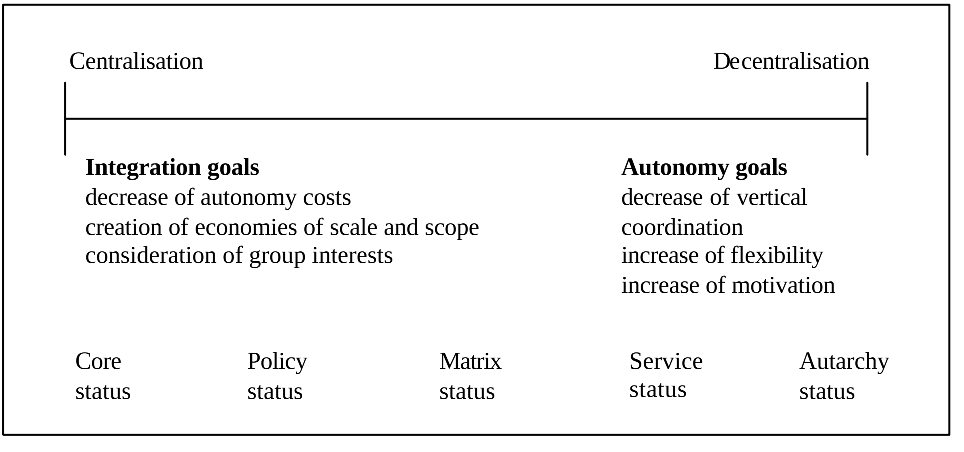

Figure 13: Goals of the (de-) centralisation of functions and corporate centre statuses

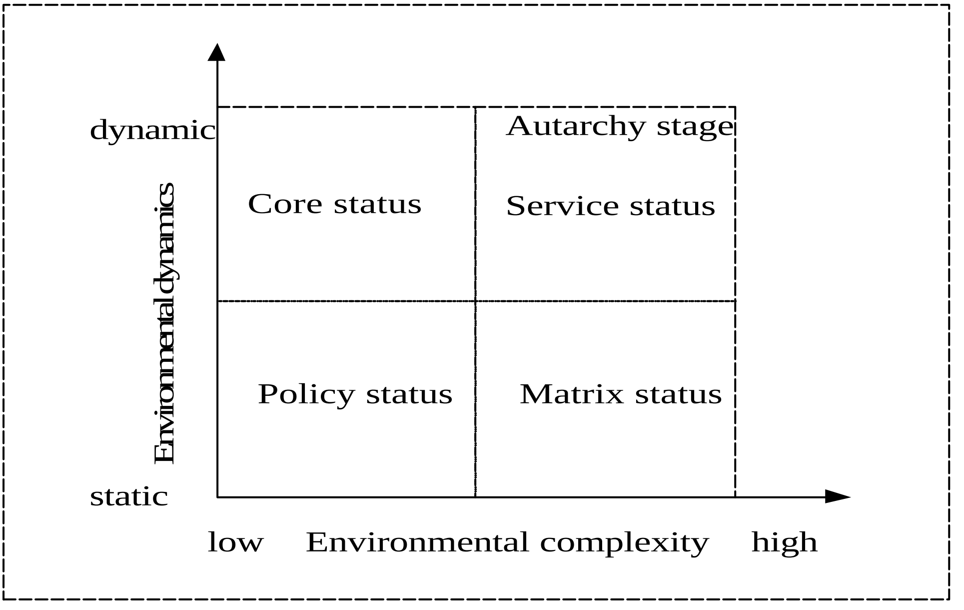

Figure 14: Complexity, dynamics and the status on the decentralisation continuum

c) Five statuses for the corporate centre

Based on Bassen (1998, p.71ff) we develop a model for (parts of) the corporate centre, which identifies five statuses on the continuum (see also Figure 13 on page 70): 1) core status: both decisions and activities are performed in the corporate centre; this also means that no other part of the organisation is involved and that the function is uniquely placed in the corporate centre; there is full centralisation, 2) policy status: decisions are taken in the corporate centre, but implementation is done in the divisions (with or without support of the corporate centre), 3) matrix status: functions are performed both in the corporate centre and in the divisions; decisions are reached through discussions in especially formed committees; the committees will determine where activities will take place, 4) service status: decisions are taken in the divisions and the corporate centre executes; the impact on the corporate centre can be further increased when external suppliers participate on service delivery or when external benchmarking is performed, and 5) autarchy status: decision and implementation i.e. complete functions are fully decentralised and no corporate centre function is present. Which status is appropriate in which situation depends on the complexity of and the dynamics in the environment in which the company operates and, as a result, of the chosen governance model and management style of the corporate centre. This is done by (market) information processing by the divisions, which then inform the corporate centre. If we use these two dimensions, complexity and dynamics, then we come to the following grid (see also Figure 14): 1) static and low complexity: corporate centre functions best performed using the policy status , 2) dynamic and low complexity: corporate centre functions best performed using the core status, 3) static and high complexity: corporate centre functions best performed using the matrix status, and 4) dynamic and high complexity: corporate centre functions best performed using the service and autarchy status.

2. Instruments of coordination

a) Characterisation of coordination instruments

Decentralisation cannot function without coordination. Coordination is done to (try to) undo the negative effects of decentralisation. We can distinguish between vertical and horizontal coordination (Bassen, 1998, p.94ff). Vertical coordination deals with decision and implementation activity as divided between hierarchical levels. Insofar the corporate centre has authority over the divisions, vertical coordination is an issue. Horizontal coordination takes place when decision and implementation is distributed over different departments, which do not relate to each other in a hierarchical manner. This concept of coordination initially takes place on the level of simple (one-way) transactions but can be juxtaposed on departments, organizational units and at the firm at large. For this study we will use the definition of Bassen (1998, p.99): coordination is implemented with the use of special instruments which manage the interdependencies between decisions and implementation in existing organisational units directed to fulfilling the firm's goals. Using different coordination instruments can support the goals for centralisation or decentralisation, and may limit the divisions in their decision-making powers. Bühner (1996) sees examples of instruments as depicted in Table 11.

Technocratic	**Structural**	**Personal**
Legal and contractual arrangements such as participations and contracts	Central services	Executive board members with different functions in the board at the same time
Group controlling	Committees	Executive board members with a function in the Board of Directors
Central treasury	Project groups	
Transfer prices		

Table 11: Management instruments of executive board members

Going into further detail, different levels of coordination can be reached by using the following indirect and direct[1] instruments: company (sub) culture, role standardisation, self-management, plans, programmes, and personal instruction. These instruments can be positioned along the continuum of centralisation and decentralisation as show in Figure 15 (based on Bassen, 1998, p.132).

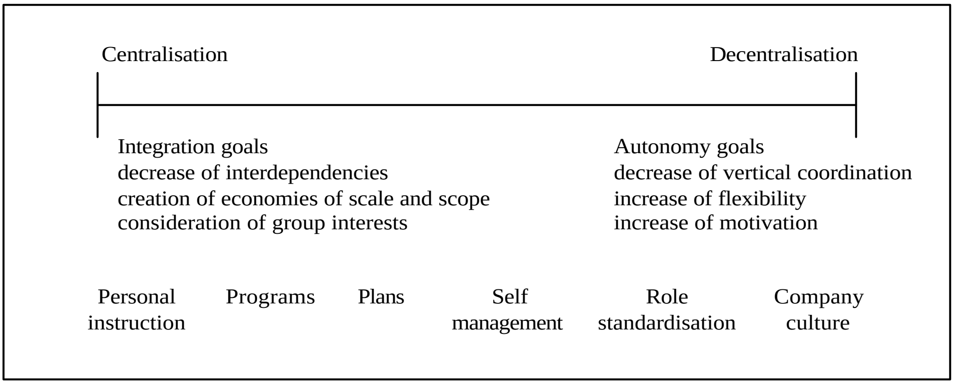

Figure 15: Positioning of coordination instruments

b) Instruments for different degrees of (de-) centralisation

Personal instruction: this is the instrument with the strongest coordinating impact and can have effect on both processes and output. It is only one authority, which coordinates with instructions. A hierarchy of decision-making authorities is a precondition. The coordinating effect of personal instruction on decentralisation is limited. Anticipating interdependencies and activities in advance, together with information dispersion will lead to high costs for integration. Personal instruction also might have a negative motivational impact. Decisions and activities can be implemented ad hoc, leading to flexibility in reaching goals. At the same time, when changes are needed, it is difficult to get them implemented, as they first have to travel up the hierarchy. If and when interdependencies and scale and scope economies are accounted for at the initiation of personal instruction, there is less need for coordination in a later stage, thereby serving centralisation well. Also, there will be no obscurity about direction and goals.

Programs: here we mean that processes are prescribed on how tasks should be performed. This leads to standardisation and a pre-coordination. These processes can be between and within organisational units. Programs might entail alternative processes, in case of changing conditions, or can be rigid. Programs coordinate because of the

[1] Indirect: not yielding immediate change; direct: at the disposition of management.

detailed uniform approach to activities. The corporate centre defines these programs. Programs do not really support coordination in decentralisation, as the detailed standardisation and top-down approach can lead to lower motivation with employees. Also using programs does not increase flexibility. At the other end, centralisation is well served by programs. Horizontal interdependencies are decreased and coordination efforts are less needed. Also one can expect a more efficient resource allocation.

Plans: here we mean the results of planning processes, which are directed towards group goals and which are time-bound. Also, although in- and outputs might be described, the way on how to reach the results is not part of a plan. Plans can contain transfer prices, goals and budgets, which all have a coordinating impact. Hierarchy between organisational parts becomes less pronounced as all participating units know they are measured on their contribution to the realization of the plan. Goals, derived from corporate strategy, picture the future and as such coordinate efforts. Budgets show operational room to manoeuvre in monetary terms. Already in the production of a plan coordination takes place. Partial plans will need coordination and therefore will produce coordination costs. At the same time, as this does not happen too often, it might be that these costs are low and result in a continued period in which no coordination is needed and the plan can function as reference. Because plans do not specify processes, plans maintain flexibility when the environment changes[1]. Plans can also be used for centralisation. Reflecting corporate plans and knowing the output, the horizontal dependencies are automatically taken care of.

Self-management: here we mean that departments are empowered to coordinate among themselves thereby excluding the need for vertical coordination. This also means that only horizontal coordination takes place. In practice and in larger organisations, this does not happen, as it is too complex; however, this is possible in small organisations. Self-management can therefore only be used for specific and selected issues and not for complete (parts of) corporate centres as such. Self-management can be used for processes and results, and to lower vertical coordination costs and may introduce compromises, which, in itself, may not fully serve (de-)centralisation to the fullest.

Role standardisation: here we mean that by experience or training, certain functions get standardised which lowers the need for coordination. This can be true for both results and processes. Again, this can be especially useful for decentralisation and we expect higher flexibility in changing circumstances. Similar to company culture, the need to coordinate via this tool is less, and therefore the use of this tool in centralising does not support coordination as much as it does with decentralising.

[1] But only insofar that these changes do not have impact on resetting of inputs and outputs.

Company (sub) culture: here we mean the shared values in (different parts of) the corporate centre: what is seen as accepted behaviour, the preference for certain (type) goals, the relationship between people and the business environment. These are shared by all employees[1]. Company culture can be used as a tool insofar this can be influenced. When a company (sub) culture is strongly present, one can expect a strong coordinating impact. Especially decentralisation can be supported by company culture; when decentralised units share the same culture, then the corporate centre needs to coordinate less. Company (sub) culture is less useful in the case of centralisation, as the need for coordination is less when functions are centralised, and therefore having a strong company (sub) culture, useful for other goals, does not support coordination greatly.

c) Concluding remarks on coordination instruments

The use of coordination instruments is affected by developments in the business environment, such as internationalisation, size of the organisation and technological developments. Here also we can use the dimensions of complexity and dynamics. Mintzberg (in Bassen, 1998, p.134ff) formulated the relationships as follows: 1) when the environment becomes more dynamic, the structure will become less bureaucratic, and 2) when the environment becomes more complex, the structure will be more decentralised. Combining these insights with the coordination instruments, this leads to the use of instruments in situations of different complexity and dynamics, as depicted in Figure 16. When we see corporate centre' activities as parts of processes aimed at a larger corporate result, then these activities by itself also influence coordination We can distinguish between known and unknown, new processes, and measurable, quantifiable and non-measurable output. Using the coordination instruments from Figure 16, we come to the relationship between output and coordination instruments, as shown in Figure 17. Combining corporate centre' output and process dimensions, and the environmental complexity and dynamics, we can make a detailed positioning of the coordination instruments. This is shown in Figure 18 (based on Bassen, 1998, p.144).

[1] In the company at large or an organisational unit.

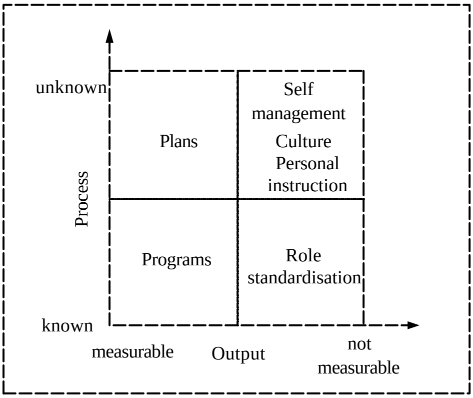

Figure 16: Coordination instruments and environmental complexity and dynamics

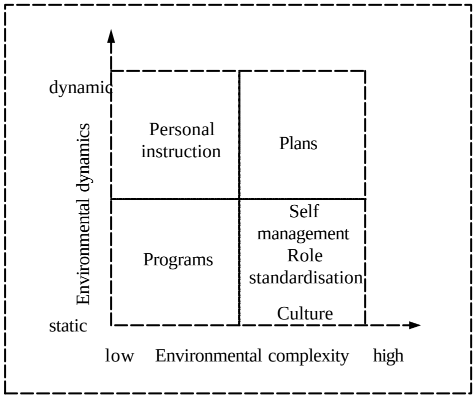

Figure 17: Corporate centre' output and process dimensions and five corresponding coordination instruments

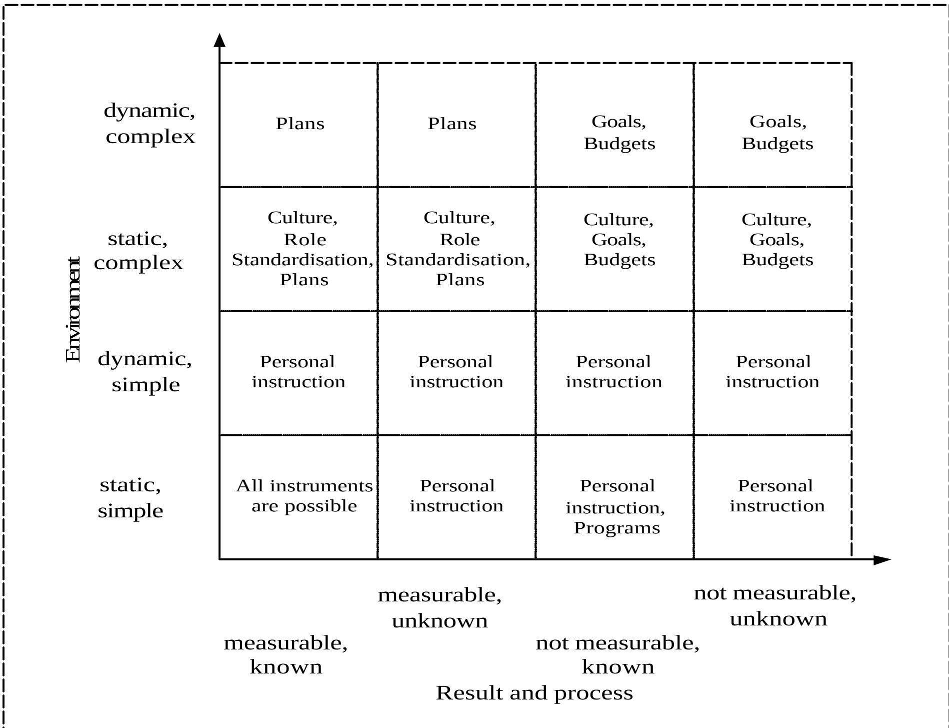

Figure 18: Placing of corporate centre' coordination instruments

3. Influence of the corporate centre in the group

a) The actual level of influence

In conjunction with issues of decentralisation and coordination stands the issue of influence of the corporate centre. Influence can be seen as the result of decisions of design and implementation of decentralisation. Although corporate management has overall responsibility of the group, corporate managers in Europe tend to believe that importance for the success of the businesses is a necessary, but not sufficient, justification for corporate centre' involvement (Young et al, 2000, p.29ff). Influence tends to be highest in the general planning areas[1]. Influence tends to be lower in the functional areas[2]. Table 12 shows to what extent the corporate centre has influence over divisions (based on Young et al, 2000 p.30, own calculations[3]). Functional influences are linked to the relatedness of the business divisions in the company. Higher functional influence is associated with greater likelihood that functions will be included within the corporate centre and greater centralisation of functional staff. Companies with greater diversity tend to have more decentralised decision-making. The table implies that companies make decisions on decentralisation and coordination resulting in the shown level of influence. The corporate centre influences decisions affecting business divisions, but the areas and the extent to which they do this vary from company to company. The mix in a particular company generally reflects both the nature of the business being managed, and the skills, preferences and background of the senior managers within the corporate centre, including their beliefs about how value can be added to the business divisions (Young et al, 2000, p.60).

General planning influences (in %)	**Europe**	**USA**	**Japan**
Setting of budgets and financial targets	71	83	73
Major capital investments	75	87	70
Business strategy/new business creation	79	73	67
General influence score	76	81	70

[1] Setting of budgets and financial targets, major capital investments, strategy and new business creation.
[2] Human resources, research and development, marketing etc.
[3] 100% would mean maximal influence, 0% minimal influence.

Functional influences (in %)	**Europe**	**USA**	**Japan**
Human resources	48	53	67
Research and development	38	53	53
Marketing	30	37	47
Purchasing/logistics	29	47	37
Property management	46	N/A	73
Information technology	55	70	70
Functional influence score	40	53	55

Table 12: Corporate centre' influence over divisions

Take the example of product development of Figure 19: if there are few overlaps in production processes between divisions, then three quarters of corporate centres feel constrained to exert minimal influence over product development decisions[1] (Young, 1998, p.935). However, if there is a high level of similarity then there is more freedom. In another example, Figure 20 shows that in UK companies in which the corporate centre had a minimal influence upon human resource decisions, over 60 percent did not have a corporate human resource function (Young & Goold, 1999, p.29).

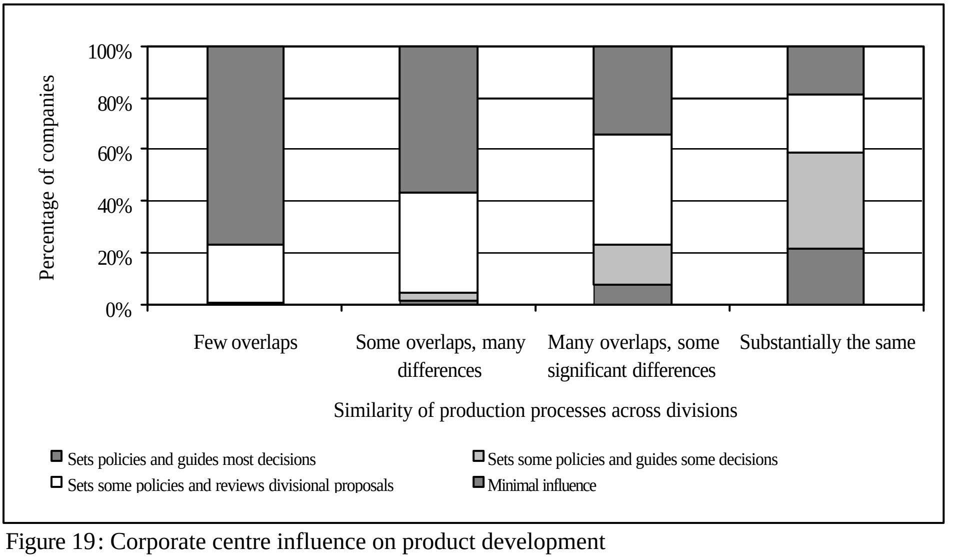

Figure 19: Corporate centre influence on product development

[1] This research was done in manufacturing industry: it is a proxy for the financial services industry.

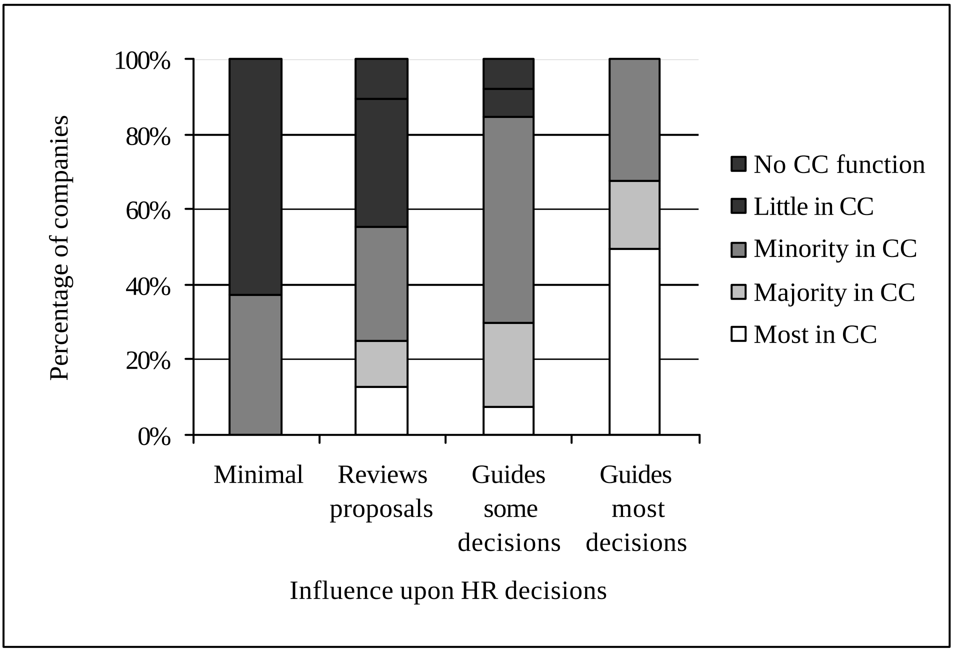

Figure 20: Centralisation Human Resource staff activity

b) The right level of influence

Of course, striking the right balance of influence, i.e. fine tuning decentralisation and coordination is problematic. High levels of influence in combination with a very diverse portfolio could indicate either that the company is too centralised in its decision-making, or that the portfolio is insufficiently focused. This lack of focus might arise in a financial conglomerate, which from this logic would call for a lower level of influence by the corporate centre. On the other hand, low levels of influence in combination with a focused portfolio could indicate that the company is missing opportunities to add value. Therefore, there must be a continuous test if the influence exercised is appropriate and effective. Feedback should continuously fine tune decentralisation and coordination policies. Equilibrium though will be hard to reach, especially when operating in a dynamic environment. Schulman et al (1999, p.33) supports this notion as they state that centralisation versus decentralisation is a false dichotomy, as neither of these models work in an environment of global competition and instant communication. Companies decentralised because centralisation led to a monolithic and insensitive corporate culture with little regard for customer needs. Decentralisation though led to the need to create duplicate infrastructures to conduct support functions.

c) The impact of influence on staffing

Although we will discuss staffing in paragraph 2.B.II.3, influence impacts staffing and costs. In general, we can see that companies with higher influence corporate centre functions are more likely to centralise functional staff and so have larger corporate centres. This becomes clear from Figure 21 (based on Young et al, 2000, p.61):

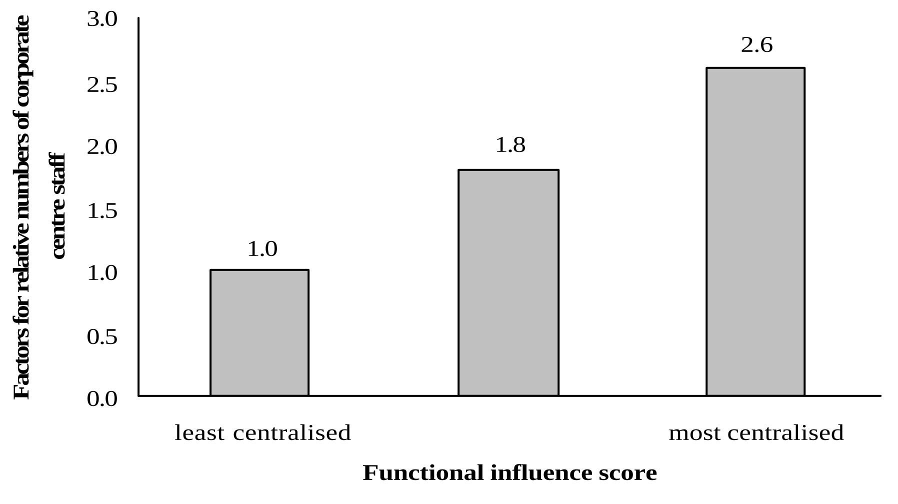

Figure 21: Functional influence of the corporate centre vs. staffing

One tool to deal with ambiguity in corporate centre influence is the use of focused committees: units which operate on a non-permanent basis; members come from different divisions. Activities can include information exchange, coordination, advising and decision-making (Hungenberg, 1995, p.266).

II. Types and roles of the corporate centre

1. Core of the existence of the corporate centre

a) Two corporate centre' models

There are two different types of corporate centres: separate and embedded corporate centres. The latter type is integrated in the main division and is most common when the company comprises either a single division, or a dominant business together with a few minor divisions (Young et al, 2000, p.18). If the minor divisions develop into more major operations, such companies tend to the separate corporate centre form. In this study we focus on the separate corporate centre. Although the corporate centre consists of the collection of central services, this does not imply all central services should take place in the corporate centre. Hungenberg (1995, p.257ff) calls this the distinction between mono- and polycentric management structures. As companies deal with globalisation, we recognise that companies can optimise their centralised services by positioning them in divisions, which, based on qualifications, regional or functional considerations, are best place for those activities. This means that operational corporate centre functions are distributed over more operational corporate centres[1].

b) Focus on the strategic role of the corporate centre

From a strategic viewpoint, we can also assume that the corporate centre is primarily there to help develop and help implement the overall corporate strategy. Without this alignment the reason for existence of the corporate centre can be questioned and the business model as such requires reconsideration. In bringing value to divisions the corporate centre can take on different roles[2]. Van Oijen & Douma (2000, p.560ff), defining a role as an instrument the corporate centre can use to manage its divisions, note that choosing the correct role or roles is essential for firm performance. Both in the literature and in practice quite some attention is given to these roles, although few authors explore the necessary detail. The role of the corporate centre is effective if the extent and intensity of business coordination reflect the potential value contribution. In changing circumstances, strategies change and the extent to which (parts of) the corporate centre plays a specific role varies. One aspect of this, the relation between the corporate centre and the extent of the diversification of the company, has been researched by Van Oijen & Douma (2000) and Van Oijen (1997)[3]:

[1] One approach is where this can take on a regional character (lead country principle). Bartlett & Ghoshal (1998) and also Suckfüll (1994) came up with the notion of the integrated network organisation. Here parts of the corporate centre are distributed over the company with one of those parts playing the leading role. Main goal is to reduce the resources needed for fulfilling the task, by using underutilised resources elsewhere. More attention though will have to be paid to matters of integration.

[2] Canals (1998, p.626) distinguishes between managing, coordinating, and advising, but leaves unexplored.

[3] Research: 67 Dutch firms listed on the Amsterdam Stock exchange (Van Oijen & Douma, 2000, p.565).

As diversification increases, the corporate centre will[1]:	**High performing companies**	**Low performance companies**
Be less involved in strategic planning for the BUs	Confirmed	X
Rely more on financial criteria then a combination of strategic and financial criteria for evaluating the BUs	Confirmed	X
Be less involved in selection of BU-personnel	Confirmed	More
Organise less rotation of personnel between the BUs	X	More
Use a more financial motivation for the BU-managers	Confirmed	More[2]
Use fewer instruments for BU-coordination	X	X
Offer fewer centralised services for BU-support	Confirmed	X

Table 13: Influence of diversification on the corporate centre

In firms with high financial performance, corporate centres adjust roles in planning, evaluation, selection, motivation, and support[3].

2. Corporate centre roles further examined

a) Roles according to Hungenberg

Hungenberg (1993, p.67ff) sees three management roles with differing intensity of coordination: 1) an operational holding is an effective role for the corporate centre if intensive influence and cross-business coordination can add substantially to the divisions values. In this case, the corporate centre is intensively engaged in decision-making processes at division level (1:1 influence). Additionally, cross-business coordination and synergy exploitation are main tasks of the corporate centre. The corporate centre controls strategic management and to a large extent also operational management of divisions. Operational holdings can be effective due to potential synergies and similar business systems of various divisions, 2) a financial holding, where the holding is directly involved in the strategic management of businesses by determining financial goals and staffing top management positions, can be effective if the potential for value enhancement through intensive 1:1-influence and cross-business coordination is small. This description frequently applies to diversified companies controlling heterogeneous divisions., and 3) a management holding ranges between an operational and a financial holding in terms of potential value contribution and intensity

[1] X means no statistically significant relationship found.
[2] strategically oriented
[3] The high performing firms, therefore, do not distinguish themselves from the low performers by being more or less diversified or more or less decentralised: the high performers have a better fit between their diversification strategy and the roles their corporate centre performs (Van Oijen & Douma, 2000, p.568).

of coordination. A management holding does not interfere with operational management of divisions, but controls strategic management tasks, involving the divisions' management to some extent. A management holding is appropriate where divisions require similar managerial skills, and where advantages of shared business systems can be exploited. Later, Hungenberg (1995) tries to make the notion of roles more tangible when he defines the roles for the corporate centre as follows (see also Figure 22): *Conductor*: here the corporate centre takes on all essential tasks with respect to divisional strategies. Characteristically, the corporate centre acts as a conductor and directs the individual player and the orchestra as a whole; *Coach*: here the corporate centre and the divisions jointly develop and agree on divisional strategies. Characteristically, the corporate centre acts as a coach who assesses performance potential of individual players and stimulates them, while at the same time he tries to enhance and develop the team play, without participating in the games himself; *Investor*: here the corporate centre takes on no influence with respect to the content of the divisional strategies. The divisions are autonomous and independent. Characteristically, the corporate centre acts as an investor who chooses the composition of his portfolio and the individual investments, which he judges on financial criteria only and which can be traded.

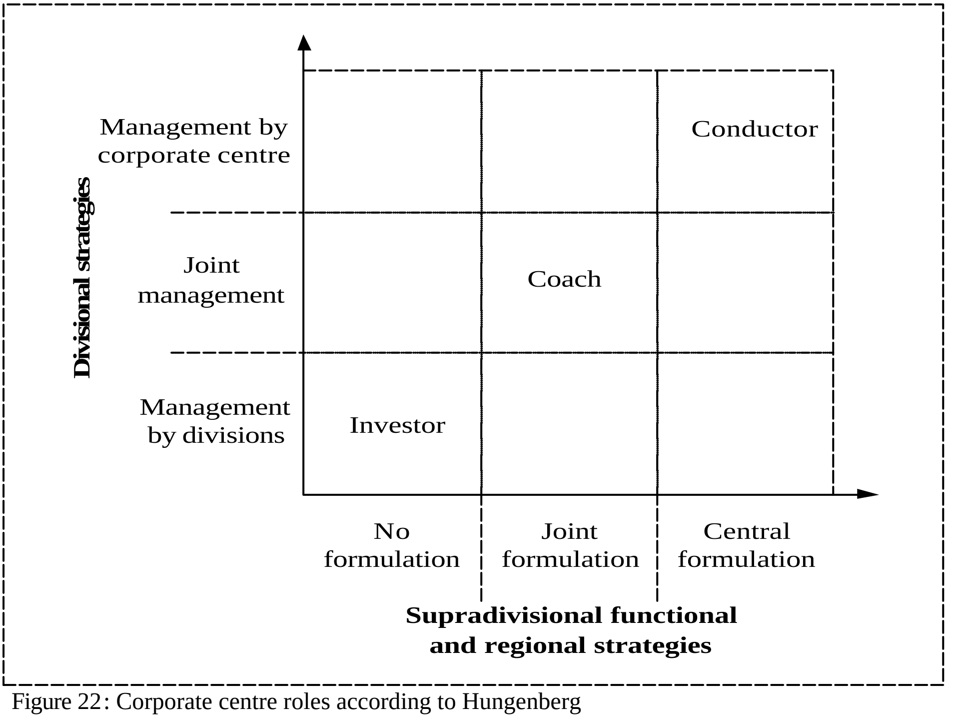

Figure 22: Corporate centre roles according to Hungenberg

b) Roles according to Young et al and Goold et al

According to Pettifer (1998a), the basic role of the corporate centre is to assist corporate management in the execution of obligations, where the corporate centre ought to match management style. According to Young et al (2000, p.9ff), the corporate centre can have three different roles (see table 14): *the minimum corporate parent role*, which enables the company to exist as a single legal entity, *the influencing and policy-making role*, which aims to add value to the businesses, and *the service provision role*, which concerns activities which are needed by the business operations, but which are believed to be provided most effectively by the corporate centre; the divisions typically have some degree of control. In close connection, Goold et al (2001, p.84) distinguish between three distinct roles as well (see table 15): *the minimum corporate parent*, *the value-added parent* and *the shared service centre*. The *first* role, called the minimum corporate parent role, involves discharging the legal and regulatory obligations of the corporation and meeting minimum standards of due diligence in corporate governance.

Role	**Examples**	**Characteristics**
Minimum corporate parent	Raising capital, basic control over business operations, meeting obligations to investors, submitting tax returns, complying with legal requirements for compiling and publishing accounts	Essential Not easily devolved to divisions
Influencing and policy making	Strategic guidance, devising, implementing and policing group-wide policies and standards, setting performance targets and monitoring progress towards achievement, providing expert advice and assistance on selected topics	Discretionary Believed by corporate managers to add value to the business divisions
Service provision	Information systems, payroll, training	Needed by divisions Could be devolved or outsourced Centralisation believed to provide economies of scale, scope or specialisation

Table 14: Corporate centre roles according to Young et al

The obligations mentioned are unavoidable and can include preparing annual reports, submitting tax returns, and ensuring that legislation is observed. Also, the corporate parent must establish a structure for the company, appoint senior management, raise capital, handle investor relations, and implement control processes for major decisions and checks on performance. The *second* role, called value-added parenting, is about how the corporate parent influences and adds value[1] to the divisions. It is therefore closely related to the company's corporate strategy. Since the corporate strategy for adding value differs from company to company, the appropriate level and nature of staff groups in this role is bound to differ. This means that benchmarking of the staff size and cost can be misleading. The *third* role, called shared services, is about providing centralised services to the divisions. These services may be standard activities, or they may be more complex services. The divisions normally have some control over the work done at the corporate centre.

Role	**Examples**	**Characteristics**
Minimum corporate parent	Raising finance. Basic control, compiling and publishing accounts, submitting tax returns	Essential Not easily devolved to divisions
Value-added parenting	Strategic guidance, stretching targets, leveraging corporate resources, facilitating synergies	Discretionary Believed by corporate managers to add value to the divisions
Shared services	Information systems, payroll, training, transaction processing	Needed by divisions Could be devolved or outsourced Centralisation believed to provide economies of scale, scope or specialisation

Table 15: Corporate centre roles according to Goold et al

c) Roles according to Van Oijen & Douma

More operationally, Van Oijen & Douma (2000, p.562ff) distinguish seven roles:

1. Planning: the degree of involvement is influenced by a firm's diversification strategy: when diversity is lower, corporate centre involvement is higher
2. Evaluation: assessing divisions' investment proposals and results and allocating resources
3. Selection: appointing personnel of the divisions so as to ensure that key positions are held by cooperative people who have an affinity with the firm's overall goals [2]

[1] Management might prefer their activity to be classified as value adding rather than core or shared services as they feel that that improves their status, provides security during reorganisat ions, improves relationships with business units, and emphasises the entrepreneurial character of their activities (Jagersma, 2000).

[2] In case of present potential i.e. limited diversification.

4. Rotation: organising rotation of personnel between divisions, which facilitates the exchange of resources between divisions and reduces cultural differences
5. Motivation: providing division managers with incentives based on the level of diversity and the performance of the individual division and the group
6. Coordination: installing mechanisms that encourage interdivisional cooperation[1]
7. Support: performing services for the divisions where firms with less diversification have opportunity to centralise functions efficiently.

These roles are being spread over the role classifications of Hungenberg and Young et al and Goold et al and can be valid throughout the corporate centre.

III. Contribution of the corporate centre

1. Propositions according to Pettifer

When the corporate centre is successful in their activities value can be created. At the same time the corporate centre should have opportunities to operate. These opportunities arise from imperfect conditions. Pettifer calls these opportunities propositions. Five types of propositions are distinguished (Pettifer, 1998a): 1) build propositions: which are about helping a business to grow substantially bigger, to improve positioning, to move into new markets or products, to make large acquisitions or merge, 2) stretch propositions: these are about supporting business to become leaner or more professional, 3) link propositions: these concern the corporate centre as facilitator to help businesses link to create synergy[2], 4) leverage proposition: corporate centres often possess valuable resources and assets that can be leveraged across businesses[3], and 5) portfolio development proposition: buying, selling and business start-ups provide further opportunities for centres to add value[4]. These propositions offer a way to think about corporate centre contribution and they can be useful in reflecting on strategies adopted by corporate centre departments.

[1] Where firms with closely related activities have large opportunities for cooperation between divisions.
[2] Five types of linkage can be recognised: know how sharing, activity sharing (economies of scale), pooled negotiating power in dealing with suppliers, unions and other external parties, vertical integration, involving trading between businesses in a way that reduces cost or improves quality, and strategic coordination, where the strategy of one business is altered to benefit the other.
[3] These include corporate brand, patents, properties, licenses and relationships.
[4] Some companies have venturing departments in their corporate centres to seek out new businesses or identify "potential" from the firm's portfolio. As projects develop, they are formed into a division.

2. Value creating activities

a) Value added on an abstract level

Hungenberg (1993, p.64) sees two possible ways in which the corporate centre can add value: definition of the business portfolio where the corporate centre defines and prioritises the company's businesses, and coordination of businesses by determination of actions and decisions at division level by the corporate centre. In a conglomerate, this means that a corporate centre can be seen as a middleman, sitting between investors and divisions; and as such, a corporate centre can only justify its existence if the corporate centre enables the divisions to continuously achieve performance it could not achieve on its own or with any other potential corporate centre, so as to make sure that the value of the group is higher than the value of the combined individual divisions.

b) Conditions for value creation

As corporate centres do not generate client-based income, the value proposition of the corporate centre is of an indirect nature. According to Pettifer (1998a, p.7) there are three positive conditions necessary for value creation by the corporate centre[1]: 1) the opportunity condition: there must be an opportunity for the corporate centre to add value: businesses must be failing to fulfil their potential[2], 2) the skills and resources condition: the corporate centre must have, or be able to acquire, the skills and resources needed to provide leverage to divisions. Especially we can think of relationships with expert centres and governments , and 3) the "sufficient feel" condition: which is about the degree of understanding the corporate centre needs for its businesses[3].

c) Added value according to Goold et al and Canals

Goold et al (1994) have presented a conceptual framework, describing the type of resources and skills that the corporate centre can contribute to the different divisions, that we can apply to financial conglomerates (see also Canals, 1998, p.632ff). The authors distinguish between four types of generic advantage obtained from good corporate management (see Figure 23): 1) decentralisation, in terms of financial and

[1] Note that Pettifer's statements for value creation by the corporate centre are qualitative in nature and prove hard to quantify in terms of monetary value

[2] The suggestion here is that there will always be the opportunity for a wise, well-resourced or well-connected corporate centre to add value by enabling divisions to perform better. Unit managers are consistently presented with challenges that they do not have the knowledge or experience to meet.

[3] Corporate centres can be highly influential and unit-level managers react strongly to signals coming from their corporate executives. If the corporate centre understands the businesses well, the signals it will give off will not only support the priorities that units should be focusing on, but also facilitate good decision-making; alternatively, lack of understanding will produce a converse effect: the signals will be unhelpful distracting the business from its priorities, or encouraging mistakes.

human resources, and a high degree of autonomy of the divisions; after appointing managers it trusts, the corporate centre will probably retain certain rights regarding the approval of operating and investment budgets and other critical decisions[1]. The advantage of this contribution is that each division acts as a competitor, 2)search for interrelationships or synergies between the different divisions; this contribution consists of the series of relationships that it can establish with the divisions and, at the same time, help them get maximum benefit from these relationships. Throughout and within the company; the focus lies on policies, organisation structures, and communication channels; these can be in areas such as information technology and human resource policies, 3) functional services shared between the corporate centre and the different divisions[2], this contribution consists of the influence the corporate centre has on the divisions, either through a more or less active presence of the corporate group's managers in the different divisions or through services that the corporate centre offers its divisions[3], and 4) corporate development guided by the corporate centre; this contribution is related to development of the group by means of investment decisions, entering new businesses, or withdrawing from businesses[4]. This includes monitoring and controlling: being able to intervene and rectify underperformance can add value; the monitoring criteria and the performance levels must be appropriate.

3. A note on the S-word: Synergy

a) Achieving synergy

One way to realise the synergy potential is to identify affinities and critical interrelationships within the group, develop and analyse value chains per division and look for common characteristics, formulation of a strategy in coordination with corporate and division strategies with goals supporting the pursuit of interrelationships, and configuration of the synergy activities (Jagersma, 2000). In these steps, different instruments can be deployed (Wijers, 1994, p.75ff): 1) change of attitude of management: recruitment of collaborating management is important, 2) structuring collaboration: here we can think of informal and formal meetings, which are supported by division management, know clear rules and are able to reach intermediate results,

[1] When markets where perfect this would not be an issue; divisions would raise financing themselves and they would recruit employees from other divisions and externally, so that each manager ended up in the place within the firm where he could add the most value – markets are not perfect though and the corporate centre plays a correctional role. Internal resource allocation can also take place faster than the external markets.
[2] There are relatively few corporate assets (such as brand names), which are genuinely independent.
[3] This may take place when the firm believes that the corporate centre provides services more cost effectively than any other provider. One has to take into account though that a third party supplier stands or falls by its ability to provide a client-focused service, and usually has far greater scale and experience than an in-house department can provide. An outside supplier is also less likely to be defeated by corporate politics.
[4] Details of transactions and implementations should be left to the divisions though.

and 3) supporting systems and procedures: compatibility of division systems, showing the synergy potential, is most important here; included are information systems but also human resource policies, incentive systems, the inclusion of synergy in planning processes, and financial systems such as internal allocation of costs and revenues.

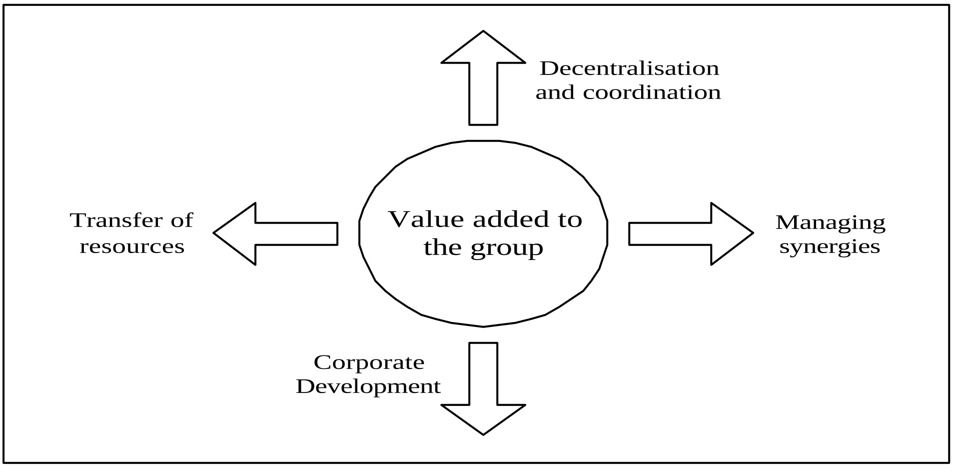

Figure 23: Contribution of the corporate centre

Figure 24 shows some possible interrelationships, which could exist between the commercial, and wholesale banking, and capital markets divisions of a financial conglomerate (Canals, 1997, p.287ff).

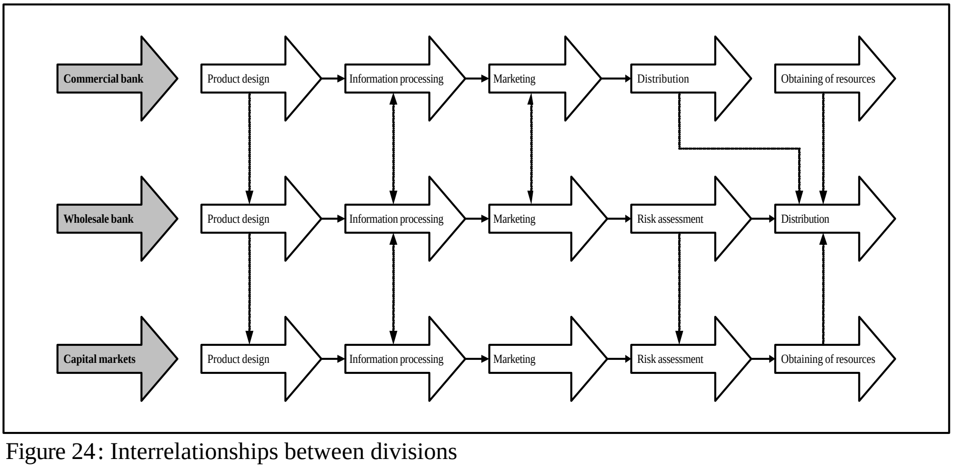

Figure 24: Interrelationships between divisions

b) Obstacles to synergy

When the corporate centre becomes active on synergies, the (perceived) costs[1] for achieving these synergies might outweigh the benefits. Further obstacles to the implementation of synergy include: 1) classic strategic planning approach: little attention is paid to coordinating division strategies; inconsistent directions making interrelationships more difficult to achieve, 2) predominant vertical structures, which are the dominant way through which top management directs activities of divisions; information, decisions and resources tend to flow only vertically; sub-units in between are designed to oversee this vertical process and reduce span of control of the corporate centre, 3) vertical organisational boundaries lead to strong identities in different divisions, and 4) symmetric benefits in interrelationships are hard to realise: this needs adjustments of incentive systems to avoid conflicts.

c) Organisational stickiness

Creating synergy by transferring best practices can be hampered by what Szulanski calls *stickiness* (Szulanski, 1996). This can be blamed on motivational factors, such as interdivisional jealousy, lack of incentives, an inclination to reinvent the wheel, resistance to change, fear to lose autonomy, fear for unfair blame for poor performance and lack of commitment. The corporate centre could reduce these barriers by adjusting its roles. Besides motivational factors major barriers to the transfer of best practices are knowledge related factors such as causal ambiguity, difficulty in establishing relations, lack of capacity to absorb new knowledge, and a difficult relationship between the source and the recipient of the knowledge.

[1] Costs include direct costs for establishing systems to realise synergies but also senior management time, loss of focus and feelings of disempowerment on the part of divisional managers.

B. Organisation and activities of the corporate centre

I. Managerial issues in governing a conglomerate

1. Business environment of the corporate centre

Although local history, institutions, and culture influence corporate centres and although there are some national differences between corporate centres in Europe, there has been substantial convergence in their size and composition (Young et al, 2000, p.77). More and more, historical and cultural differences fade and the corporate centre has to take into account factors, primarily affecting the different business divisions, as these factors influence corporate centre strategy and activities. One dominant trend, which we have discussed discuss in paragraph 1.C.I, is the upcoming interest in the concept of the creation of shareholder value. Here divisions and the corporate centre are being judged based on their contribution to the creation of shareholder value. What also are impacting the corporate centre are the changes in the business environment at large (Hungenberg, 1993, p.62): 1) increasingly, companies are active globally while at the same time companies much get closer to their customers. Corporate centres are often (too) far away from clients and from competitive relevant information to come to fast and business-oriented decisions. This implies that decisions on business issues must lie with the divisions, 2) the application of new technologies in order to develop markets develops faster and faster. This means that decisions dealing with these developments more and more have to be taken by the divisions instead of the corporate centre, 3) managers and employees strive for more responsibility and entrepreneurial freedom and are less willing to accept influence from a far away corporate centre. This influence could disorder business operations and would have a negative impact on the motivation divisional managers, and 4) the necessary knowledge and experience to deal with business issues increases enormously. Also, this knowledge has to build up in shorter times. This means that the knowledge in the corporate centre might not match the knowledge needs of the divisional managers. Here it would be better to have the knowledge centres close to the business within the divisions. A special case occurs when companies are active in a regulated industry, such as financial services. Regulated companies are subject to influence by (quasi-) governmental bodies and it is noticeable that they tend to have larger corporate centres: the corporate centres of regulated companies are around 30 percent larger than those of non-regulated publicly quoted companies (Young et al, 2000, p.67ff)[1][2]. Executive managers in financial services

[1] Young et al (2000, p.67) note though that in their survey this difference was not statistically significant.
[2] E.g. in Germany median staffing of corporate centres of financial services companies was 140 per 1000 employees against only 4.5 per 1000 for industrial companies; legal, financial reporting and control, human resources and information systems functions contribute substantially (see also paragraph 2.B.III.3).

companies have to be approved by regulatory authorities and financial soundness is subject to constant supervision. It may be easier to respond to these regulatory needs through a centralised management structure. (Quasi) government supervision introduces additional administrative overheads, and the lack of competition associated with operation in regulated industries tends to permit higher costs.

2. Organisational problems with governance

a) Agency, moral hazard and coordination

Canals (1997, p.115ff) discusses different governance problems with financial conglomerates from the standpoint of Organisational Economics[1]. A *first* specific problem of conglomerates is the *agency problem*, which is generated between corporate centre managers and division managers. In general, agency problems appear as soon as there is a separation between the owner and the manager or employee who must carry out the plans drawn up by the owner or the top manager[2]. *Moral hazard* may arise between the divisions and the corporate centre. An example is where financial operations requiring fast decisions and a great deal of decentralisation are required, with funds being allocated to the various units to handle autonomously[3]. A *third* organisational problem faced by conglomerates is that of the costs of *coordinating* the various divisions. In general, coordination problems arise as a result of specialised work performed by different people or different units within an organisation[4].

[1] A term introduced by Milgrom & Roberts (1992).

[2] The principal offers the agent a contract so that the latter may carry out a certain activity. In turn, the agent may have information that the principal does not have. There can be two types of asymmetric information problems. The first is that the agent has private information, which leads to adverse selection problems. The second is that the principal cannot control the agent's actions, which generates the problem called moral hazard. As a comparison, in a specialised bank the agency problem is that the incentives of the managers of each of the financial conglomerate's divisions may or may not be compatible with the corporate centre's general objectives. The agency costs in financial conglomerates consists of the costs of designing the explicit contracts between the corporate centre and the divisions, the cost of supervising them, and the cost of ensuring fulfilment of the commitments that have been taken on. Such contracts do not have any legal force but rather are involved with e.g. the creation of goals and policy systems, which the corporate centre decides to apply.

[3] This case raises two different aspects of the moral hazard problem: 1) the nature of the information that flows from the division to the corporate centre. The problem is that this information is usually conveyed after the operations have been carried out. Therefore, once the operations have been executed, the decisions are already irreversible and can only be offset, if negative, by better operations in the future, and 2) the division's agent usually earns an additional bonus linked to profits gained from his operations, while he does not lose part of his salary if the operations lose money. In other words, his income structure is asymmetrical and benefits from making high-yield decisions, which are those that bear most risk. However, the consequences of negative results in high-risk operations are borne not by the agent or the unit in which the agent works, but by the financial conglomerate as a whole; this problem also exists in specialised banks but financial conglomerates have a higher complexity.

[4] Each person or unit usually has partial or incomplete information about the rest of the organisation. Consequently, it is vital to find formulas that enable this information to be shared and achieve efficient actions. One of the specific goals of this coordination in a financial conglomerate is to use the supposed synergies that exist between the different divisions to achieve concrete results such as a lower general cost level or increased revenues. The coordination problem has particular aspects in financial conglomerates that

b) Design, motivation and the cost of influence

A *fourth* organisational problem is related to the coordination problem. This is the so-called *organisational problem with design attributes* (Milgrom & Roberts, 1992, Bolton & Farrell, 1990). Business problems with design attributes are those that occur in any organisation when the information available to make reasonably good decisions is very abundant and, furthermore, when the cost of not making the right decision, or of not achieving the right degree of coordination between the various individuals taking part in it, can be very high[1]. A *fifth* organisational problem in a financial conglomerate is the *motivation problem*, which occurs on two organisational levels. The first is between employees in the same division. This is a common problem in any specialised bank, so we will not discuss it here. The second is the problem of the compensation systems and career patterns followed by managers with the same ability and training in different units, e.g. the commercial bank and the investment bank[2]. *Finally*, there is an additional problem that occurs in financial conglomerates, typical for complex organisations. This is the so-called *influence cost* and belongs to the general problem of rent-seeking activities: those activities that are not productive and which seek to modify income distribution between different groups[3]. In financial conglomerates influence costs arise in those activities or decisions that seek to transfer costs or income[4].

c) Focus of managerial concern

In order to solve these complex organisational decision problems facing financial conglomerates, it is necessary to combine two indispensable elements. The first consists of using those organisational forms that minimise, a priori, the costs deriving from the inefficiencies described above. One concrete way of doing this is through a holding

make it different from the coordination problem within a specialised bank. There are several types of solution to coordination problems: an organisational design that takes into account the different information requirements of each of the agents involved in the process, correctly allocating each agent's responsibilities, creating formal communications channels between the various agents involved, and setting up control and compensation mechanisms.

[1] In such cases, highly decentralised solutions do not work well. At the divisional level, problems with design attributes arise when economies of scale, economies of scope, or complementary qualities are obtained between the products offered (Bulow et al, 1985). When any of these circumstances exists, the best solution usually consists of centralising activities in an organisation.

[2] These divisions have different competitive features and different skill demands. It is therefore logical that the motivations be different. However, these differences could generate a certain amount of distrust between managers in different divisions, which could destroy any possibilities of co-operation between different divisions. In general, designing compensation systems designed to avoid opportunistic behaviour by decision-makers proves difficult.

[3] An example: the defence of protectionist interests for certain sectors of the economy.

[4] For influence costs to be incurred in an organisation, there must be decisions that establish ways of distributing costs and profits within the organisation as a whole. If influence costs are inevitable, the question raised is whether they can be controlled or their impact minimised. There are some general criteria for achieving this objective: decentralise the resource-allocation and decision-making process as much as possible; try to limit the negative consequences of possible income redistributions.

organisation structure in which each business becomes a unit with a high degree of autonomy but with certain performance measurement systems and reward and internal promotion mechanisms that facilitate co-operation between divisions; in other words, the aim is to design systems that truly enable benefits to be gained from the possible synergies that (may) exist within a financial conglomerate. The second element required is the eradication of those inefficiencies. The only way to achieve this goal is for the organisation's top management to create the conditions so that the financial conglomerate has opportunities not only to earn money but also to learn and work in an atmosphere of trust. Historically, in companies where the primary concern has been the ability of the corporate centre to support strategy the overall trend has been to increase the scope of corporate centre activities (Young et al, 2000, p.44). In contrast, where the primary concern has been the cost-effectiveness of corporate centres the broad trend has been to reduce the scope of the corporate centre.

3. Drivers of change for the corporate centre

a) Different change agents

Regarding anticipated changes corporate centre's size, Young et al (2000, p.40ff) found that factors, which drive this include change in the overall size of the company, in the level of influence corporate managers have over divisional decisions, in the level of services provided to the business divisions, and concern about the cost-effectiveness of the corporate centre (see also Table 16). Costs, number of staff and number of corporate centre functions all appear to be falling in Europe and Japan (Young et al, 2000, p.39ff). In contrast, managers in the United States believe that their corporate centres are getting larger. With the exception of Japan, outsourcing is widely believed to be increasing. The tendency is for corporate managers to have a stronger influence over decision-making, and for more services to be provided by the corporate centre. Central service provision is growing most widely in the United States. According to Young et al (2000) change driven by concern about corporate centre's cost-effectiveness tends to lead to reductions in the scope and staffing of corporate centre activities. Change driven by concern about corporate centre' ability centre to support strategy often leads to increases in the scope and staffing of the corporate centre. Drivers for change in 1995-2000 were the change in the portfolio of businesses and in corporate strategies. For the years 2000-2005 staff numbers are expected to fall while the influence of corporate centres on divisional decisions and services provided to the divisions are expected to increase. Tables 17 and 18 show the developments[1].

[1] E.g.: in European companies where the primary concern is corporate centre' ability to support strategy 12% of those companies respond that they will reduce the number of corporate centre headcount; based on Young et al (2000, p.42ff), own calculations.

% of companies where driver is of major importance	Europe	USA	Japan
Drivers of past change were			
Change in portfolio of businesses	27	34	29
Change in corporate strategy	45	33	26
Ability of the corporate centre to support strategy	42	29	N/A
Cost-effectiveness of the corporate centre	40	34	71
Drivers of future change are			
Overall effectiveness of the corporate centre	71	39	73
Corporate strategy effectiveness	55	N/A	N/A
Ability of the corporate centre to support strategy	64	37	N/A
Cost-effectiveness of the corporate centre	65	47	N/A

Table 16: Drivers of change for the corporate centre[1]

	Europe		**USA**		**Japan**	
Change	realised	expected	realised	expected	realised	expected
% of companies de- or increasing	1995-2000	2000-2005	1995-2000	2000-2005	1995-2000	2000-2005
# corporate centre staff	-21	-26	19	-13	-39	-70
Services bought by corporate centre	32	28	37	40	-3	10
Influence of the corporate centre	15	14	27	20	N/A	N/A
Services provided by corporate centre	14	7	36	30	7	8

Table 17: Change in corporate centre staffing in different regions[2]

Companies where primary concern is	Ability to support strategy		Cost-effectiveness	
% of companies de- or increasing	Europe	USA	Europe	USA
# corporate centre staff	-12	-7	-41	0
Services bought-in by the corporate centre	12	71	36	50
Influence of the corporate centre	19	29	4	25
Services provided by the corporate centre	9	29	7	42

Table 18: Expected corporate centre's change with varying focus

[1] E.g.: in Europe 27% of the firms in this research answered that change in the portfolio of businesses was a driver of change
[2] E.g.: in Europe, 21% of the firms realised a decrease in corporate centre staff in the period 1995-2000

b) Operational difficulties

In pursing corporate centre goals, management will run into different difficulties. These difficulties are depicted in Figure 25 (Pettifer, 1998b, p.14). Operationally, difficulties encountered with the corporate centre include 1) excessive costs: corporate centres are often too large because of functional empire building and senior management requests for information based on historical reasons, 2) lost opportunities: seeking opportunities for value creation should be the essential role of the corporate centre, and 3) damaging influences: corporate centre management exercises significant influence over divisions; because of this, thought needs to be given to the way such influence is employed.

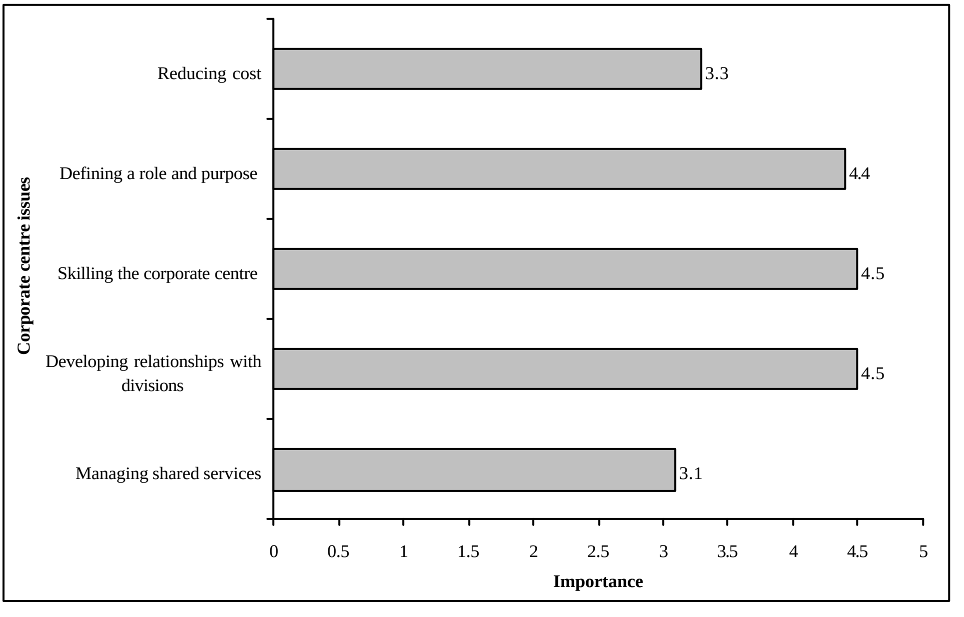

Figure 25: Corporate centre issues and their importance

II. Corporate centre management styles

1. Existence of styles and mechanisms

In assessing the effectiveness of the corporate centre, Campbell & Goold (1998) made a distinction in terms of management style. They defined three styles used by the corporate centre: 1) Strategic Planning, 2) Strategic Control, and 3) Financial Control.

The different styles cause value to be added in different ways[1]; none has proven to be inherently best. The three styles form part of a continuum of ways the corporate centre can influence divisions. The continuum has two dimensions: 1) the planning influence, which expresses the degree to which strategy is centralised, and 2) the control influence, which shows the importance firms attach to short-term financial targets. For corporate level managers, managing a multiple-business company, five trade-offs or areas of tension can be identified: 1) leadership versus autonomy, 2) coordination and co-operation versus clear responsibilities and accountability, 3) thorough analysis and planning versus entrepreneurial speed and responsiveness, 4) long-term strategic targets versus short-term financial targets, and 5) flexible strategies versus tight controls. The three management styles exist as a result of the development of three different positionings against these tensions. In Figure 26, firms that fall in the bottom left-hand corner are labelled holding companies. In such organisations, the corporate centre has little influence over the subsidiaries. The top right-hand corner of the matrix is blank because this style appears to be infeasible[2]. In having influence in assessing divisional performance, Young et al (2000, p.31) define the different stages as follows: 1) flexible strategic: some weight given to achievement of budgeted targets, but substantial weight given to other criteria, including progress towards longer-term, non-financial targets, 2) tight strategic: primary focus on budgeted targets, but some weight given to other criteria, including longer-term, non-financial targets, and 3) tight financial: predominant focus on achievement of budgeted targets. Along these lines, Young et al (2000) found how corporate centres managed the groups as shown in Figure 27[3].

Campbell & Goold (1998, p.485) defined eight mechanisms through which the various corporate centre management styles can de effective[4]. These mechanisms are tools that the corporate centre uses to influence strategy and actions. They are 1) the organisation structure, 2) the planning process, 3) the use of themes, thrusts, or suggestions to guide managers, 4) the degree to which the corporate centre manages overlap between the units, 5) the resource allocation decisions taken by the corporate centre, 6) the objectives set for each unit, 7) the closeness of monitoring results against objectives, and 8) the types of incentives applied to managers who meet or fail targets. Each style uses these mechanisms in different ways and extent.

[1] Each adds value in a specific way and each can subtract value.
[2] Some companies have tried to combine a high degree of planning influence with tight short-term controls, but they have moved away from it. A seemingly oppressive corporate centre demotivated either divisional managers, or the corporate centre failed to maintain sufficient objectivity to keep the controls tight.
[3] Own calculations.
[4] The assumption here is that the corporate centre can only be effective if it successfully influences the strategies and actions of divisional managers for the better.

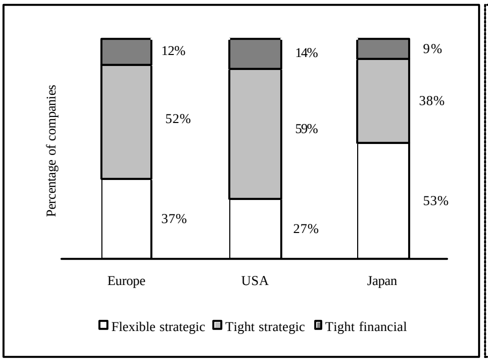

Figure 26: Assessment of divisional performance

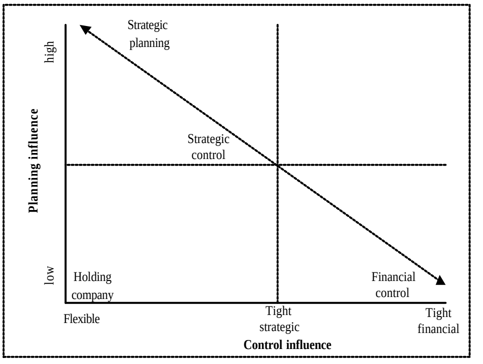

Figure 27: Figures styles matrix

2. Strategic Planning

a) Organisation structure, planning process and leadership

The complex and overlapping *organisational structures* of these companies ensure that a variety of views on strategy will be expressed. They also allow the corporate centre to inject its ideas into the formulation of strategy, a wider discussion of issues and a more comprehensive search for new strategic options than would occur in an independent company. Co-ordinating committees also allow strategies to be drawn together across a variety of businesses (or countries) to achieve benefits of synergy and integration that would not be available to separate companies. And strong staff groups at the corporate centre allow economies of scope in the provision of central services. The drawback of this structure and the emphasis on co-operation and co-ordination is that divisional managers have less clear-cut individual responsibilities. The inevitable price or multiple viewpoints and synergy is some loss of autonomy. This, in turn, can reduce motivation, unless a shared purpose compensates for the loss of individual responsibility. The extensive *planning processes* of the Strategic Planning (SP) companies are an important means for getting different views aired. They are a test of divisional thinking, and can help to prevent businesses from falling into outdated or inappropriate strategy patterns. The questions posed by the central management should be much more informed, much more strategic, than is possible for the outside investors to whom the independent company reports. This is a prime value of the planning process of the SP-company. The need to communicate and justify plans to the corporate centre inhibits freedom of action, slows down the decision process, and takes some ownership from lower levels of management. The independent company can be swifter and more entrepreneurial. Furthermore, SP-processes are often cumbersome and confusing rather than probing and insightful. The drawbacks of bureaucracy in planning may not be intrinsic to this style, but it is a potential pitfall. By providing strong central *leadership* through themes thrusts, and suggestions, the companies are able to embark on bolder, more aggressive strategies than would otherwise emerge. Central sponsorship can enlarge the ambitions of business management, ensure that resources are available to support investments and help to overcome risk aversion. Close involvement by the corporate centre in strategy development inevitably reduces both the objectivity of the corporate centre in reviewing strategy, and the sense of personal ownership at the divisional level. Strong leadership can be seen as autocratic or ill-informed interference that overrules division-level ideas.

b) Resource allocation and control system

Resource allocation and objective setting in the SP-companies are aimed at the long-term development of the business. The corporate centre acts as a sort of buffer to the capital market, protecting the divisions from the need to satisfy he short-term performance criteria applied by the outside investor. Too much emphasis on strategy and the long-term endangers short-term issues in that they might be overlooked having a negative profit impact. For long-term performance defining and monitoring clear, objective and measurable goals is difficult and this opens up the possibility of excuses. Linked to this is that SP-companies are prone to undue optimism about the future or to personal incentives that are not linked to strategies. Lacking market disciplines and clear internal targets, the atmosphere can become too cosy. This can mean that flexibility becomes tolerance, and tolerance becomes looseness. Motivation to perform is then at risk. Furthermore, replacing the verdict of the stock market with subjective corporate assessments of strategic progress may not be an unmitigated gain. It is in these circumstances that corporate 'politics' flourish, with decisions taken to reinforce personal positions in the hierarchy, rather than to improve the strategies of the business. Finally, the flexible *control system* in the SP-companies adds value. By accepting that precise, short-term targets may have to be compromised in order to stay on track to build a business, it encourages a more tenacious pursuit of long-term goals. The corporate centre in the SP-company is more sympathetic than the capital market to the manager who is struggling to create a major new business in a highly competitive and uncertain world. Flexible controls, however, can never provide clear and objective standards of performance. Hence it is harder for both the corporate centre and the divisional manager to know whether results are on target. The price of flexibility is ambiguous performance measures and a reduced sense of personal accountability. The SP-style is characterised by an emphasis on strategy, long-term objectives, and on a co-operative flexible management approach.

c) Conclusion on the Strategic Planning style

Table 19 summarises the key features and the added and subtracted value of the SP-style. The negative features of this style can be minimised by sensitive, flexible, and selective planning processes, leadership, well-informed central management, shared commitment, avoiding over optimism, strategy-aligned incentives, and strenuous efforts to identify, measure, and act on strategic milestones.

Key features	**Added value**	**Intrinsic subtracted value**	**Pitfalls**
Complex, co-ordinated structure	Wider discussion of issues Synergy Central services	Less individual responsibility and authority	Can reduce motivation
Extensive strategic planning process	More thorough search for best strategies	Less freedom of action Slower decisions	Can be cumbersome, confusing or bureaucratic
Strong central leadership	Bolder strategies Shared purpose and commitment	Less ownership by business Less objectivity by corporate centre	Can become interference Can lead to risky and over ambitious strategies
Long-term criteria	Building core businesses Buffer to capital market	Slower reactions to adversity Less clear targets	Can lead to over optimism, 'lip service'
Flexible controls	More tenacious pursuit of long-term goals More innovative, responsive strategies	Subjective assessments Less accountability	Can lead to politics

Table 19: Summary of the Strategic Planning style

3. Financial Control

a) Organisation structure, planning process and leadership

At the opposite extreme to Strategic Planning lies Financial Control (FC). The *organisational structures* of the FC-companies stress multiple, separate profit centres, each with independent responsibilities. As far as possible, these structures replicate, for the profit centres, the circumstances of independent companies. The profit centres are set up so as to overlap as little as possible, and no attempt is made by the corporate centre to co-ordinate between them. The profit centre manager is largely free to run his department without interference from other parts of the company. It gives early general management responsibility, thereby developing the skills needed for the long-term success of the company. But the structure is less ambitious than that of the Strategic Planning companies. It adds no value in comparison to the independent company situation but at least it avoids the negatives that are also associated with the more complex structures of Strategic Planning companies. The *planning process* in the FC-companies concentrates on budgets. The emphasis is on the short term, and on agreeing targets rather than on the means. As with Strategic Planning companies, the corporate centre probes the plans of divisional managers, but the nature of questioning is very different. For FC-companies the primary value arises from the pressure it creates for high-level standards of profitability and growth of profits, not from probing underlying strategic logic. The FC-companies add value by asking for performance that is more demanding than that insisted on by stockholders, and they exert pressure for performance much more continuously. As a by-product of the tight budgeting process, managers may also have to think again about the validity of the strategies they are following. If they are unable to satisfy corporate requirements, they may be forced to consider changes of direction. But the corporate centre will not typically question strategies directly, or expect to make much contribution to the definition of new and preferable strategic options. And the emphasis is on next year's results, not the long term. The focus on results-not-strategies leaves managers more free to make their own decisions, provided they turn in the required performance.

Furthermore, the planning process can be simpler and therefore less prone to bureaucracy than in Strategic Planning companies. The major drawback of the planning process is that it cannot claim to add much value to the business manager in probing and thinking through his strategic options. Indeed, the short-term results orientation may distract him from tackling long-term issues. If the stock market is felt to create an unduly short-term orientation, the FC-style serves to reinforce this bias. Taken to extremes, the style can encourage managers to milk their business by cutting back too far on investment. Although the corporate centre may make occasional suggestions, business *autonomy* is preserved in the FC-companies, by insisting that the final decision rests with divisional management and by avoiding any broad top-down corporate themes, missions, or thrusts. This philosophy attempts to replicate the freedom of the independent company and hence can obviously add little value when compared to it. If, however, constructive suggestions are made, but not imposed, the divisional manager may gain something that is denied to his fully independent counterpart. Nevertheless, it is clear that FC-does not attempt to add as much value in this respect as Strategic Planning; equally, however, it runs fewer risks of subtracting value.

b) Resource allocation and control system

The *resource allocation* process in the FC-companies adopts objectives and criteria similar to the capital market. There is no attempt to buffer the businesses from requirements for short-term profit. Rather, capital market criteria give confidence in ability to deliver. The system reviews each investment on its merits, rather than as part of a long-term business strategy. It adds value by insisting that proposals will only be funded if they project high returns and fast paybacks, and if divisional managers appear committed to achieving their forecasts and have a track record of doing so in the past. The corporate centre does not pretend to have a detailed knowledge of each division's business, or to be able to criticise, shape and add value to the strategies behind the investment proposals. The corporate centre is more directly active in acquisitions and divestments. Value is added to these acquisitions by increasing their profitability through the application of FC-disciplines. Conversely, divestments are made of businesses that do not respond to these criteria. The emphasis on short-term profit objectives in resource allocation and acquisitions simplifies the management task, but it can result in missed opportunities. The tension remains and means that the FC-style will always create problems in businesses where long time scales are needed.

The main strength of the FC-style is in the *tight controls* it imposes. Not only are budgets stretching, and do investments demand short paybacks, but also the monitoring of results achieved and the feedback from the corporate centre create strong incentives to deliver. The knowledge that there will be a speedy reaction to under (or over-) achievement of (monthly) targets does create increased motivation. The simplicity of the criteria for judging performance also makes it easier for line managers to know where to focus their attention. This is one of the prime motivating factors for successful managers in the FC-companies and has two benefits. It makes for a more open discussion of business issues with the corporate centre, since the line manager can rely on his results rather than his words to impress the corporate centre; and it creates a 'winner's' psychology among divisional managers which makes them feel more capable of overcoming obstacles and pushing on to further peaks of performance. But the tight control process also has its downside. It can stifle creativity, snuff out experimentation, and eliminate the entrepreneurial skunk works activities. There is less flexibility to respond to opportunities. At its worst, tight control can mean that everything is sacrificed to meeting specified control objectives at whatever cost to the underlying health of the business.

c) Conclusion on the Financial Control style

Table 20 summarises the key features and the value contribution of the Financial Control style. The negative features of this style can be minimised by: targets that require year-on-year profit growth, employing divisional managers long enough so as to confront them with the consequences of their strategies, informed central managers who offer suggestions without imposing their views, willingness to override objectives if it is clear that they damage the health of the business, a winner's psychology to maintain growth momentum, and acceptance that, sometimes, this style may be inappropriate.

Key features	**Added value**	**Intrinsic subtracted value**	**Pitfalls**
Separate profit centres	Simplifies task Early general management responsibility	No coordination synergy	
Budgetary planning	Higher standards Challenges that won't deliver Avoids 'potholes'	Distracts from strategic issues	Can encourage milking the business
Business autonomy	Advice, not instructions	No co-operation, no 'help' for divisions	
Short-term criteria	Clearer criteria 'Efficient' internal capital market	Missed opportunities 'Control games'	
Tight controls	Faster reaction More motivation 'Winner's' psychology	Less flexibility and creativity	Can become a straitjacket

Table 20: Summary of the Financial Control style

4. Strategic Control

a) Organisation structure, planning process and leadership

The Strategic Control (SC)-style is a blend of the features found in the Strategic Planning and Financial Control styles. By structuring themselves around *individual profit centre businesses* that are grouped into divisions, SC-companies claim to achieve the motivational benefits of decentralisation, while allowing important business overlaps to be managed at the divisional level. There is some added value from divisional coordination, but a minimum of interference with divisional managers. But even if the divisional level is able to achieve synergies between divisions that would not be achieved independently, it is less clear how the corporate level adds value, structurally, to the divisions. As in Financial Control companies, the decentralised structure leaves little room for the corporate centre to orchestrate the several divisions in the portfolio. SC-companies argue that they have a prime contribution to divisional thinking via the quality controls in the *strategic review process*. The disciplines provide a continuing challenge that sharpens the thinking in the divisions and businesses. By its probing, the corporate centre raises minimum standards of thinking and analysis, and prevents 'habits of mind' from forming. The intention is similar to that of Strategic Planning companies, although SC-companies limit themselves to a questioning role, and do not propose their own views from the corporate centre. Extensive planning processes can run into the same problem of acting as a constraint that was described for the Strategic Planning companies. Moreover, bureaucracy grows quickly in SC-companies because the corporate centre is that much more distant from the business. The corporate centre may fail to be well enough informed to ask useful questions or that any benefits may be more than offset by the time-consuming and costly processes that they involve. Corporate planning processes do not always deliver net added value. Only if these processes are sensitively designed and administrated, and if the businesses in the portfolio are likely to respond to a second view can value be added by the corporate centre. SC-companies generally *avoid major suggestions and initiatives* and are not active in co-ordinating between divisions or businesses. Also they recognise that direction from the corporate centre can subtract value. They stress the responsibility and independence of the divisional manager. Where ad hoc interventions do take place, research indicated that value was subtracted at least as often as it was added.

b) Resource allocation and control system

It is in a *resource allocation process* that balances long- and short-term goals that the corporate centre of many SC-companies add the most value. The corporate centre provides access to a pool of resources, which can be made available for investment in long-term, large or risky projects. These projects might be turned down by outside investors, who have little knowledge of the business and who are often short-term or fashion driven in their attitudes, focusing more on past results that future prospects, and failing to assess technically complex or strategically innovative ideas. The downside of the long-term investment attitude is the same as in the Strategic Planning companies: a danger of undervaluing the importance of next year's profits. But the SC-companies attend to defend against this problem by balancing long-term objectives with short-term profit pressures. The ability of companies to cut back drastically in some their portfolios, while preserving growth momentum elsewhere, is evidence of their ability to make trade-offs. Indeed, major corporate resource allocation decisions in the SC-companies have concentrated at least as much on portfolio rationalisation and profitability improvement as on long-term investment. In practice, there are numerous difficulties in achieving the right balance of objectives. Assessing more speculative, longer-term investments is hard. If the corporate centre lacks close familiarity with the business, it may be forced to rely on the credibility of the sponsoring management team together with formal financial evaluations - much the same criteria as used by the outside investor. Where the corporate centre backs long-term projects, the reason may be personal commitments to a business rather than clear-sighted strategic thinking. Reliance on corporate funds for investment can also be a source of problems since capital scarcity can cut out investments that might have been funded by the outside market. Although portfolio rationalisation improves profitability ratios for the SC-companies, it is less clear that divisions of these companies would have moved any less speedily to take corrective measures had they been independent. SC-companies may move more decisively on rationalisation and exit decisions than Strategic Planning companies, but the discipline of the outside capital markets would in some cases have been more pressing than that provided by corporate management. The resource allocation process in the SC-companies therefore attempts to combine the buffer function of the Strategic Planning companies and the efficiency function of the Financial Control companies. In some respects this achieves the best of both worlds, but in others it encounters the disadvantages that come from the lack of a clear commitment to either. This follows from the more basic tension between short- and long-term goals. Furthermore, uninformed long-term investments, naïve portfolio pruning, and partisan preference for particular businesses are all potential, if avoidable, pitfalls for SC-companies. It is therefore only if the corporate centre is genuinely better informed, close to the business, and as objective as the outside investor that value is likely to be added. Detailed monitoring and reporting allow the corporate centre to pinpoint shortcomings more precisely; and incentives and *tight strategic and financial controls* create personal motivation in a much less blunt fashion that the outside capital market, where take-overs or palace revolutions are effectively the only sanctions against non-performing management. So, provided that the control objectives are conducive to the prosperity of the business, SC adds value.

c) Conclusion on the Strategic Control style

Table 21 summarises the key features and the contributed value of the Strategic Control style. The negative features of the style can be minimised by flexible planning processes, willingness by the corporate centre to spend time to get close to divisional strategies, to be knowledgeable about competitive environments, avoiding over optimism, personal incentives aligned with strategy, and strenuous efforts to identify, measure, and act on strategic milestones.

Key features	Added value	Intrinsic subtracted value	Pitfalls
Decentralised profit centres Divisional coordination	Little by corporate centre	No central coordination	
Extensive strategic planning process	Raises minimum standards of thinking Challenging habits of mind	Constraining	Can be bureaucratic; add cost, but little value
Business autonomy			Gratuitous suggestions
Long- and short-term criteria	Acceptance of longer-term investments Balanced objectives	Ambiguous objectives	Tolerance for low performers Capital rationing Uninformed investments
Tight controls	More motivation to perform	Risk aversion Subjective balancing of objectives	'Politics' 'Lip service'

Table 21: Summary of the Strategic Control style

III. Corporate centre activities and staffing

1. Conception of the corporate centre

a) Possible activities

Bühner (1996) found that a corporate centre consists of two distinct parts 1) the group executive board, and 2) centralised departments. A closer look learns that the responsibilities of the group executive board can be distinguished as follows: 1) management activities: here the activities are aimed at supporting the business, both at present and in the future. The activities are strategic in nature and deal with the build up and fostering of new sources of profits within the group[1], 2) synergy activities: here the activities are aimed at creating added value by centralising know how or non-divisible resources and lowering costs, and 3) coordination and control activities: these

[1] One way of building this new business internally is the transfer of know-how within the group. Transferring external know how, e.g. by takeovers, also supports this goal.

activities are aimed at the steering of divisions among themselves, and the tuning of their activities towards corporate goals. Over time, Bühner (1996, p.15) sees a shift in the notion of the corporate centre services. Table 22 explains this. Corporate centre functions are especially organised in centralised departments to deliver management services, management support or implementation support, separately from the divisions (Hungenberg, 1995, p.250). Aim is the uniform approach to group management.

Characteristic	**Traditional notion**	**Progressive notion**
Priority goal of the corporate centre	Realising synergies Management support	Creation of added value by increasing demands on divisions
Tendency to centralise	High, because of stable business environment	Low, because of unstable business environment
Responsibility for central services cost	Not present	Present by distinguishing between cost, service and profit centre
Option for the corporate centre to offer services to third parties	Not present	In principle the market option exist
Option for division to acquire central services externally	Divisions are required to use internal services	In principle the market option exist
Benchmarking of central services to external suppliers	Not present	Present

Table 22: Traditional versus progressive notion of central services

b) Design of the corporate centre

In designing a corporate centre, it is useful to *start* with the *core* role. Here, this core role is a matter of ensuring that all corporate obligations can be professionally discharged, while weeding out unnecessary activities that may be value destroying. The *second* step is to identify the major intended sources of value added by the corporate centre, each of which should have the potential to make a measurable impact on corporate results. Staffing and support processes are essential. Companies that can find no major value added opportunities should consider to demerge, or to retrench the corporate centre to the core role only. The *third* step is to focus attention on shared services. In order to decide which activities are appropriate for concentration in a shared-services unit, an analysis is needed on what activities are unique to the division and strategic to the division's relationship with its customers, and what activities are common to all divisions and non-strategic.

c) A note on shared services

Combining shared services can result in cost savings of 20 to 50 percent while improving service levels (Gunn, in: Goold et al, 2001, p.88). Also, according to Schulman et al (1999, p.38), 20 percent of Fortune 500 companies are actively pursuing shared services. In order to manage shared services in the corporate centre, the mindset has to be established that it is a business. This means that there must be (Schulman, 1999, p.32) a strategic plan, a notion of delivery channels and cycle times, a product plan, key metrics, continuous benchmarking, an internal customer and results focus, competitive conditions, a focus on revenue and profit, active marketing, and a focus on the value chain of the shared service[1]. Divisions should be allowed to opt out if they are not satisfied with the services[2].

2. Functions in the corporate centre

a) Review of corporate centre functions

Case study research (Bühner, 1996, p.23ff) suggests that companies had the following functions in the corporate centre as in Table 23. It must be noted though that not all groups of companies have the listed functions, or that the list is exhaustive[3].

[1] Schulman et al (1999) offer a detailed approach to implement shared services
[2] The services that are most part of shared services are Finance, Information Systems Management, Human Resources, Legal, Communications, and Supply Management (Schulman et al, 1999, p.7).
[3] Here we left out Distribution and Technological R&D as this applies differently for financial service firms

Function	**Separated in**	**Main activities**	**% of companies**
Finance and control	Finance, controlling, accounting	Mergers & acquisitions, participations, liquidity management, strategic investment planning and control, financial resource allocation and control, financing of subsidiaries, analysis of results and deviations, information systems, group wide planning & control, cost structure analysis, P&L-planning, annual reporting, ruling on capitalising of assets, consolidation	100
Human resources		Human resource development, coordination of group wide human resource marketing, management standards, assessment centres, meetings with employees, administrative services for subsidiaries, strategic, contract and social issues	75
Management development		Management development of senior officers	31
Group administration	Tax, legal, audit, insurance, patents	All audit issues, group wide insurance, legal counselling for subsidiaries, tax consulting for subsidiaries, tax optimisation of the group, group wide management of own patents and licenses	100
Public relations		Coordination of public and investor relations affairs	94
Group strategy development		Setting of strategic direction supported by planning instruments and strategic goals for subsidiaries	81
Marketing		Market and competitor analysis, coordination of marketing activities of subsidiaries, analysis of product life cycles, new product introductions	31

Function	**Separated in**	**Main activities**	**% of companies**
Information technology [1]		Activities are industry specific and can be very diverse; examples include know-how transfer, security, maintenance and consulting, coordination of hardware deployment, centralised data processing	25
Procurement		Centralised purchasing strategies and logistics	31
Others		Coordination of corporate type services within subsidiaries, real estate services, trade relations	75

Table 23: Basic functions in a corporate centre and their frequency of occurrence

Individual features of divisions have decisive influence on the distribution of functions between the corporate centre and the divisions (Canals, 1998, p.631). Bühner (1996) found that different industries[2] showed different frequencies of occurrence for functions. In their research Young et al (2000) found the functions in the corporate centre of financial services firms as shown in Table 24.

[1] The activities in this field are very varied as they depend on the industry in which the company operates. A straightforward comparison is hard to make.
[2] He looked at trade, industrial and mixed groups.

Function	% of companies including function in corporate centres	
	Europe	*USA*
Legal & company secretary	92	100
Treasury	70	100
Financial reporting & control	100	83
Taxation	96	100
HR-policies & management development	90	100
Government & public relations	87	100
Internal audit	94	100
Information systems & telecoms	69	100
Pensions, payroll administration	70	100
Corporate planning & development	90	100
Training & education	67	100
Accounting for business	45	100
Property services	21	100
Purchasing	48	67
Office services	23	83
Marketing	36	50
Research and development	15	17
Distribution	16	50
Other corporate staff	37	33
Risk management & insurance	24	50
Health, safety & environment	6	17
Security	6	17
In-house communications	0	50

Table 24: Corporate centre functions in financial conglomerates

So, in designing the corporate centre functionally, we can benchmark our results against these findings.

b) Outsourcing of corporate centre functions

If we depart from the notion that a corporate centre has all corporate centre functions in-house, then outsourcing might form an opportunity to financial services firms' corporate centres[1]. An advantage is usually derived from outstanding depth in selected human skills, knowledge bases, or other service strengths that competitors cannot reproduce and that lead to greater demonstrable value for the customer (Quinn et al, 1990, p. 60). An element of competition is introduced, when outsourcing is based on competitive conditions. In sourcing professional services from outside firms, four selection criteria apply to the selection decision (Day & Barksdale, 1992, p.86): 1) perceived experience, expertise, and competence of the service provider, 2) The provider's understanding of the firm's needs and interests, 3) the professional service provider's relationship and communication skills, and 4) the likelihood of the professional service provider conforming to contractual and administrative requirements.

The main idea is not to use the threat of outsourcing to force employees into submission so much as to develop a clear and shared understanding of internal competencies, a common understanding of the departments vital to the corporate centre, and an urgency around the need for improvement. In determining outsourcing the following steps have to be taken (Quinn et al, 1990, p.64): 1) defining each activity as a service that can either be produced internally or sourced externally, 2) answer the questions if the financial conglomerate has or is able to achieve the needed level of capabilities for this service; if so, should the firm make it a part of its strategy, if not, what possibilities exist for outsourcing the activity or forming an alliance with another firm which does have superior capabilities, and 3) focus on two sets of activities: those where it can create unique value and those it must control to maintain its supremacy in managing the critical elements. Already now, firms outsource corporate centre functions[2]. These functions now have changed from back-office to front-office staff, focused on output instead of input and are motivated by profit targets (The Economist, 2001, p.56). There are indications that savings range from 20 to 50 per cent, based on lower headcount, increased process efficiencies and the change from fixed cost to variable cost of the outsourced activity. In looking at costs (savings) over the period of a potential functional outsourcing contract, it may seem logical to use the function's total cost from the accounting records, apply some future inflation rate, and estimate the future costs. There are risks to this shortcut (Greaver, 1999, p.130ff):

- The nature of current and/or future costs within the function may vary by activity
- The nature of current and/or future external costs, related to the function, may vary by activity

[1] Outsourcing tendencies might lead to an increase in what can be called contract banking (Llewellyn, 1999). In contract banking, banking services and processes are being subcontracted to external companies, with the financial services firm being a manager of a set of in- and external contracts. A financial services firm becomes a broker between the customer and a set of outside contractors whose activities make up the range of financial products and services (Llewellyn, 1999, p.37ff).

[2] According to Gartner Dataquest, the worldwide finance and accounting outsourcing market could grow from US$ 12 bn in 1999 to almost US$ 38 bn by 2004, with contracts covering increasingly sophisticated services.

- Seldom does it occur that all of a function's activities get outsourced or disappear when outsourcing occurs
- Seldom does it occur that there are not additional, supplemental costs that result from outsourcing, which may vary by activity.

Unless the nature of the costs are analysed at the activity level, these nuances are likely to be missed, which can have the impact that targeted cost savings cannot be realised. Generally, not all costs of the function's activities does not get outsourced: the nature of the function's management activities may change, from managing people to managing a provider relationship, but a *managing* activity still exists[1]. Outsourcing can bring also additional costs or even poor performance[2]. In their survey, Young et al (2000, p.34) found to what extent companies already outsource their corporate centre functions; this is shown in Table 25[3].

Function	**% of companies where cost of bought-in services exceeds cost of own staff**	
	Europe	USA
Accounting for business	6	0
Corporate planning and development	20	9
Distribution	4	0
Financial reporting and control	10	19
Government and public relations	19	9
Health, safety and environment	3	0
Human resources policies and management development	6	20
Information systems and telecoms	28	16
In-house communications	0	0
Internal audit	8	40
Legal and company secretary	13	15
Marketing	17	0

[1] The costs of managing outsourced services have recently declined, thanks to cheaper communication, the standardisation of web-based tools and the speed with which companies are automating their own data services (Auguste et al, 2002).
[2] The functions, which are seen to qualify best for an outsourcing analysis include Legal, Taxation, Internal Audit, Training & Education, Corporate Planning and Development, Government & Public Relations, Information Systems, and Property Services.
[3] A successful example comes from Canada, where in 1996, the Royal Bank Financial Group, Bank of Montreal, and Toronto Dominion Bank formed a shared document processing organisation called Symcor. Co-ventures offer organisations more direct control and say over how the services are performed and are likely to be a good long-term strategy, a function of size and magnitude, to minimise the risk of turning over services wholly to a third party (Quinn, 2000, p.15). The scale has to be present to justify the capital investment but is well worth considering since it offers cost savings, leveraging economies of scale and still retaining a say in how the operation runs.

Function	**% of companies where cost of bought-in services exceeds cost of own staff**	
	Europe	USA
Office services	5	50
Other corporate staff	8	0
Pensions, payroll, benefit administration	8	19
Property services	9	27
Purchasing	11	0
Research and development	13	0
Risk management and insurance	10	0
Security	5	0
Taxation	17	13
Training and education	27	38
Treasury	4	7

Table 25: Outsourcing of corporate centre functions[1]

Corporate centre functions that outsource a greater proportion of their activities tend to employ fewer staff. Notwithstanding this, they are not as small as might be expected (Young et al, 2000, p.33). In Europe, departments for which the cost of bought-in services is the same as the cost of their own staff, have between 25 and 30 percent fewer staff instead of 50 percent fewer staff. (Young et al, 2000, p.74). Figure 28 on page 115 shows the relation between outsourcing and corporate centre staffing levels: it becomes clear that as outsourcing increases, the net positive effect in staff levels decreases.

3. Corporate centre staffing

a) Relations in staffing levels

On a micro-level, staffing levels are results of managerial decisions. However, in their study, Young et al (2000) found the following relations. For Europe the core role, which is defined as the joint activities needed to enable the company to exist as a single legal entity, typically accounts for around 40 percent of corporate centre' staff, whereas in the USA it accounts for around 25 to 40 percent, and in Japan around 20 percent. In different countries the staffing levels for the discretionary roles (added value and shared services) tend to be higher than for the core role and have much wider ranges. In the

[1] As an example: in Europe 20 percent of the firms have costs for outside corporate planning and development services, which is higher than if performed in house.

United Kingdom, *shared services* consists of 43 percent of total corporate centre staff. Larger companies tend to have larger corporate centres[1,2].

Figure 28: Outsourcing and corporate centre staff levels

Total # employees in the company	# of firms	Corporate centre staff: lower quartile	Corporate centre staff: Median	Corporate centre staff: upper quartile	Staff per 1000 employees: lower quartile	Staff per 1000 employees: Median	Staff per 1000 employees: upper quartile
< 5,000	46	16	28	93	5.2	9.7	26.9
5 – 10,000	38	24	38	91	3.3	5.4	11.8
10 – 20,000	31	65	100	290	4.7	6.7	20.0
20 – 50,000	26	90	144	254	3.3	5.8	9.0
> 50,000	37	182	350	725	1.7	3.1	8.0
All	178	33	96	228	3.4	6.2	13.9

Table 26: Corporate centre staffing vs. firm size (Europe)

1 For example, Young et al found that in Europe the median headquarters staffing for 46 companies with fewer than 5,000 employees was 28, but for the 37 companies with more than 50,000 employees the median was 350, more than ten times higher.
2 Total numbers of corporate centre staff can be misleading when making comparisons between firms of different sizes. Expressing staff levels as a proportion of total staff employed in the firm helps to make the comparisons more meaningful.

Corporate centres that place greater emphasis on non-financial criteria tend to be larger (see Figure 29). It may be that assessing a broader range of non-financial criteria requires more corporate centre staff across a range of disciplines. The extent to which the corporate centre provides services to divisions has a substantial influence on corporate centre staffing. Typically, corporate centres that have more than 40 percent service staff have around three times the number of staff as those with fewer than 20 percent service staff. This factor is 1.7 for service staffing ranging from 20 to 40 percent (see Figure 30). As the company size doubles, the size of the minimum corporate parent staff tends to increase by no more than about 50 percent with each doubling, which indicates that significant economies of scale in core role activities are possible. The corporate centres of highly diversified conglomerates are around half the size of those of manufacturing companies, suggesting a more decentralised approach to corporate management. On average, commercial financial service companies have three times and pure retail financial service companies four times the corporate centre staff as manufacturing companies. Although firms in the financial services industry have more linkages between divisions (see Figure 31), it is unlikely that this accounts for the larger corporate centre by itself. Goold et al (2001, p.87) found that the level and nature of corporate centre functional influence is a driving factor in shaping the number of corporate centre staff. Large corporate centre staffs are not generally rated more effective in supporting corporate strategy than small ones. It is the skills of the staffs and the value-added from their activities that matter more than their numbers or cost. At the same time, large corporate centre staffs are fully justified provided that they are genuinely needed to support value creation. Interestingly, as opposed to industrial firms, in financial services firms, staff in e.g. treasury, risk management and information systems, to some extent unique to financial services firms, are often regarded as being part of the corporate centre and therefore corporate centre staffing can be substantially higher in financial services firms than in industrial firms (Young et al, 2000, p.109ff).

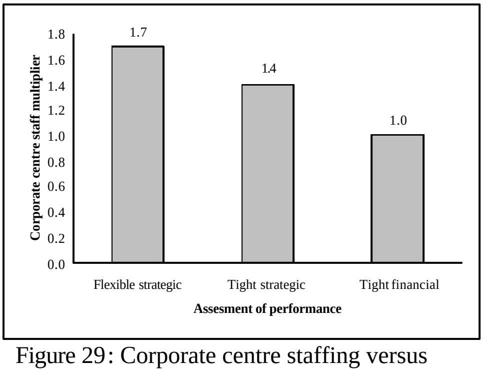

Figure 29: Corporate centre staffing versus control influence

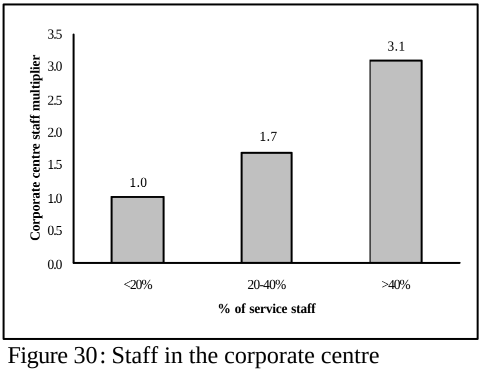

Figure 30: Staff in the corporate centre providing services

b) Actual staffing of the corporate centre

Young et al (2000) surveyed over 600 companies in Europe, the United States, Japan and Chile on corporate centre staffing levels. Distinguishing between the core role and the discretionary roles (see also paragraph 2.A.II.3), Young et al[1] found the staffing levels for financial services companies as shown in Tables 27 and 28[2].

	Europe	USA
Median corporate centre staff per 1,000 employees	56	80
# of companies	29	6
Median minimum parent staff per 1,000 employees	11	13
# of companies	19	5
Median discretionary staff per 1,000 employees	41	65
# of companies	19	5

Table 27: Corporate centre staffing statistics: financial services firms, Europe/ USA

		Corporate centre staff			Staff per 1,000 employees		
Country	**# of firms**	**lower quartile**	**median**	**upper quartile**	**lower quartile**	**median**	**upper quartile**
France	6	675	1,550	2,213	12	58.7	209.3
Germany	9	514	1,450	1,825	81.5	140.4	611
Netherlands	3		80			15.6	
United Kingdom	11	106	160	398	7.2	9.2	18.4

Table 28: Corporate centre staffing in financial services firms within four European countries

Also, it is interesting to note that Young & Goold (1999, p.19) found for UK-firms a staff distribution in three roles as shown in Figure 32.

[1] It was the first survey on this topic with this degree of depth and sheds light on corporate centre staffing practices.
[2] Partly based on own calculations.

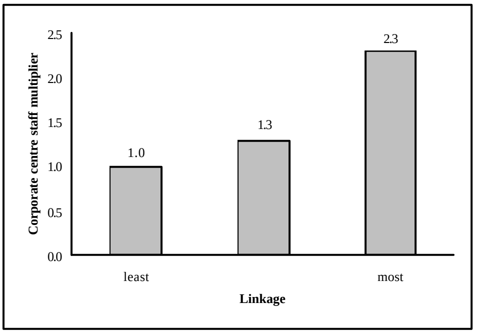

Figure 31: Interdivisional linkages and corporate centre staffing

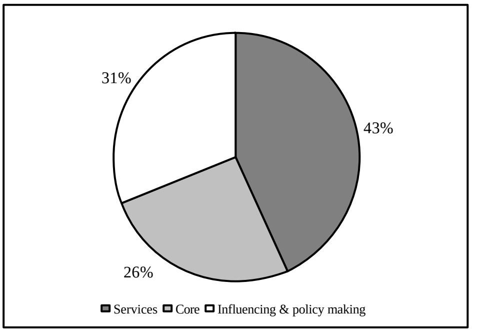

Figure 32: Average part of corporate centre staff in three roles

On a more detailed level, Young et al (2000) found the median staffing levels per corporate centre function for financial services firms as shown in Table 29.

	Median staff per 1,000 employees	
Function	**Europe**	**USA**
Legal and company secretary	2.5	4.6
Treasury	0.3	1.3
Financial reporting and control	3.5	1.8
Taxation	1.0	1.2
Human resources policies and man. development	2.3	0.7
Government and public relations	0.7	1.1
Internal audit	1.3	2.7
Information systems and telecoms	18.3	34.2
Pensions, payroll, benefit administration	2.0	1.5
Corporate planning and development	0.7	0.9
Training and education	1.3	1.6
Accounting for business	0.3	4.6
Property services	1.1	3.9
Purchasing	0.2	1.9
Office services	2.1	2.5
Marketing	0.1	2.0
Other corporate staff	4.6	0.0
Risk management and insurance	0.3	0.1
In-house communications	0.0	0.1

Table 29: Staffing levels per corporate centre function in financial services firms

c) Approximation of the staffing level in the core function

Since the core role activities are fairly similar from firm to firm, benchmarking the size and cost of these functions against other companies is useful. From their survey, Young et al (2000, p.111) came up with a simple calculation model for staffing the *core* role of the corporate centre. Table 30 shows an example for a core role of a corporate centre of a financial services company[1]. Although this model, and benchmarking, does give some direction on staffing levels, we have to bear in mind that any one firm is unique in its structure, business mix and resources. Decisions to staff up a corporate centre have to be taken carefully. An example to staffing issues: if two senior corporate centre managers want to consult a lawyer at the same time, the legal department might feel it is essential to have a lawyer available for each. In fact, the legal department will consider it essential to have two lawyers available in case the two senior corporate centre managers want to consult a lawyer at the same time. Corporate centre staffing policy can contribute to excessive costs in three ways: 1) the sanctity of specialisation inhibits evening out the workload, 2) the desire to have capacity for the maximum load leads to overstaffing, and 3) the desire to build indispensability leads to elaboration of procedural activity. In other words, many of those corporate centre managers may feel it essential to be staffed to handle the maximum load they can anticipate, even though such load would be abnormal. Managers might expect to receive more criticism for not handling promptly all demands placed on them than they do for increasing their expenses. Consequently, normal corporate centre staffing policy may be to have adequate personnel not to handle average minimum load but to cover maximum load.

[1] Turnover/ employee is based on an industrial firm; safest is to choose the highest turnover.

Company A (USA)	**50,000**	employees		
Financial service industry	**300,000**	US$ turnover pe r employee		
	Low	functional influe nce		
Baseline median financial services firm		**Model** 87	**Company A** 87	**Calculation** **87**
Location	Europe	1.00		
	USA	1.27	*Choose factor*	*times*
			1.27	**1.27**
Employees	2,000	0.34		
	5,000	0.63		
	10,000	1.00		
	20,000	1.59		
	50,000	2.94	*Choose factor*	
	100,000	4.68		*times*
			2.94	**2.94**
Turnover per employee in US$	75,000	0.77		
	150,000	1.00		
	300,000	1.30	*Choose factor*	*times*
			1.30	**1.30**
Functional influence	**Low**	0.71	*Choose factor*	*times*
	Medium	1.00		
	High	1.05		
			0.71	**0.71**
Quartiles	Europe	0.71		*makes*
		1.42		**300**
	USA	0.67	**0.67**	**0.67*300=201**
		1.50	**1.50**	**1.50*300=450**
Core role		Lower quartile		**201**
Staffing		Upper quartile		**450**

Table 30: Model for corporate centre’ core function staffing

This attitude toward staffing is grounded in part in the fundamentally dispensable character of corporate centre functions. Because this policy inevitably leads to overstaffing for the normal average load, it may result in a situation where there is actually insufficient utilisation under usual conditions.

C. Corporate centre economics

I. Corporate centre controlling

1. Controlling philosophy

a) Implications for controlling

Control of corporate centre costs should be initiated at the highest level. In the eyes of shareholders, ultimate responsibility for profits rests on group management. Control of corporate centre costs should not be delegated in full to corporate centre department managers. In corporate centre functions is no clear relationship between costs and profits as exists in production; the effect of corporate centre costs on profit is only in aggregate. Consequently, corporate centre staff has no such direct profit motivation as exists in commercial divisions. No company, furthermore, adds staff with the expectation that they will affect compensatory savings in corporate centre costs. Control of corporate centre costs requires determination of the essentiality of the corporate centre activities performed. Group management should make the decision as to essentiality, insofar the functions are a regulatory or other group necessity, or by the division manager who will be charged with the cost and will be hold accountable for results. Each possible category of corporate centre service requires a different approach. They are controllable in different ways at various organisational levels. Maybe more than in any other important aspect of company operations, effectiveness of corporate centre control reflects the attitude and style of senior corporate management.

b) Profit centre orientation

In developing the profit motivation of those in functions not directly related to business activities, i.e. in the corporate centre, one way to keep the issue of corporate centre expense under consideration is to turn the corporate centre into a profit centre. This requires the corporate centre to have revenues (see also paragraphs 2.C.II and 2.C.III); these revenues can be allocations based on replicated market-oriented prices. Thus the corporate centre can have both revenues and expenses, and the balance can be said to represent a profit or loss to its own account. This approach does a great deal to insure a consistent attitude toward general corporate centre expense. It permits the adoption of the same methods of forecasting and reporting of variances used in the divisions[1].

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[1] However, we could expect every corporate centre function to seek some means of developing external sources of income. While such activity would have an important effect on the motivation of people in these corporate centre profit centres, the diversity of problems it would bring to senior management would take a great deal of attention away from the management of the group.

c) Success and challenges of corporate centre controlling

When the controlling organisation has helped to increase line managers' performance, then corporate centre controlling can be seen as successful. This implies that the controlling function has to be aligned with the corporate strategy and infrastructure. The basis for this controlling infrastructure, is formed by (Schierenbeck, 1997) a value-based cost management philosophy, an organisational responsibility for cost management, an institutionalised controlling cycle for cost management, and an appropriate cost information system for controlling. Challenges though include striking the right balance between effort and usefulness of results, the direct measurement of value creation, benchmarking relatively unique holding services, and owning or outsourcing certain controlling activities (Fiole & Pop, 2001, p.400).

2. Awarding a controlling mandate

a) Importance of corporate centre controlling

Control of corporate centre costs is not only analysing expenses. It is also the application of expenses to strengthen the performance of divisions. This statement can even apply in the area of general corporate centre costs, where specialised functions often seem to assume the character of separate entities having their own validity irrespective of their essentiality of the divisions. The control system itself can have the effect of structuring the corporate centre so that cost and control bear on the organisation where use is made of it. The area of general corporate centre costs remains largely amorphous, and it is here that supervision assumes a special character. As controlling corporate centre cost is more a management than a spending problem (Jagersma, 2000) and because of the importance and special nature of this function, an especially formed mandate is justified. General corporate centre expense is to be supervised by an especially appointed executive, the corporate centre controller (CCCL). As supervision takes place over a great diversity of activities, he cannot rely on his own knowledge, therefore, either to manage the activities of corporate centre departments or to speak for them. It is in the specialised nature of corporate centre functions that they must be conducted by those performing them. Supervision of these areas, then, is different from supervision in the divisional lines where organisational level is normally equivalent to depth of experience in that line. The CCCL provides the essential management link required by both senior management and the corporate centre department. The CCCL should have a direct reporting line to the Group Controller, who is responsible for group-level controlling standards, processes and reporting.

b) Corporate centre controlling as a management task

The financial aspects are at the heart of control and the principal element in supervision. They are the areas in which the CCCL must be a competent manager:

- He can be the one to whom managers look to for divisional projection, for budget, planning, investment and performance review processes
- He can be the authority to spend, once plans are approved
- He can be the one to whom senior management turns for information and recommendation in matters of corporate centre costs, and in that area he is expected to speak with authority
- He can be the instrument through which management effects changes in corporate centre costs
- Corporate centre departments look to him, also, as the source of company policy in its effects on them, the interpreter of company plans insofar as they affect their own planning, and their executive contact for adjudication of interdepartmental matters in which they have a position
- He can be the point at which they apply pressure on management for innovations
- He can be the source of studies and analyses of more efficient ways to perform corporate centre functions, particularly in the area of overlapping procedures
- He can be the enforcer of a corporate centre cost reduction plan.

The CCCL can expect to be exposed to two opposing forces 1) the need to delegate responsibility as the company becomes larger and more complex, and 2) the desire to centralise control over the performance of functions at subordinate levels.

c) The corporate centre controlling program

The purposes of a program of corporate centre controlling are to limit costs in corporate centre cost categories and to develop efficiencies in the performance of corporate centre functions similar to those that have been developed in divisions. The objective is to strike the right balance between the corporate centre’s efficiency and effectiveness. The functions of planning, control, and supervision of corporate centre costs can be delegated only to a level superior to the corporate centre functions themselves. That is virtually untenable unless it receives the full support of the most senior level management. It is in the areas of the corporate centre that tendencies toward empire building can be quite pronounced.

3. Controlling activities

a) The core of controlling

Planning and control is an ongoing loop in which both activities are continuously performed and intertwined. This loop is the core of the controlling activity. The planning & control process has different levels: 1) goals and problem analysis, 2, 3 and 4) development of decision proposals, 5) decision and implementation, and 6) supervision and analysis of deviations. Figure 33 illustrates this process (Schierenbeck & Lister, 2001, p.32ff). Controlling, finalising the process, functions as the link between planning- decision-, and implementation processes. On level 1, goal and problem analysis, the controlling function does not set business goals, but develops these. Controlling activities include representation of value-based management in the discussions on goal setting, making perceived goals operational and concrete, (initial) assessment of the goal system on endurance, consistence and practicability, periodic assessment of the goal system and input for overhaul of goals, ad-hoc and situation-specific problem analysis. Levels 2, 3 and 4 focus on the development of concrete decision proposals and include the search for and analysis of alternatives, forecasts and assessments. Alternatives might prove difficult because these might only be suitable independently or in conjunction with other measures. Also, suitability might change over time, which would require constant attention. Furthermore, environmental dependencies might influence the alternative's feasibility. Forecasts deal with scenarios and picture possible outcomes in case of a choice for an alternative. Controlling activities here include: 1) limiting the forecast issue in terms of the required level of precision both and time span, and criteria of virtue such as verity, probability, level of confirmation etc., 2) cleaning of relevant data and analysis of causes, 3) development of a forecast model, testing its practicability, delivery and use of information, production of a forecast and clarification under which circumstances the forecast is valid, 4) development of forecasts of different alternatives, appreciation of the alternatives, choice for forecast, which fulfils quality criteria best, 5) estimation of the probabilities of forecasts, and 6) test of forecasts with respect to practicability.

What cannot be solved is the discrepancy between demands on the quality of the forecast and the limited possibilities for arrival at informative and definite forecasts. A comparing assessment of these forecasts is necessary to distinguish to what extent the alternatives reach their goals. The goals need to be stated in measurable criteria. The comparison takes place after weighing these criteria and choosing a measurement scale. As normally more goals are pursued simultaneously, a synthesis has to take place in which all these goals and criteria are ranked. As probability is a central element of any alternative, risk analysis, as part of the assessment of alternatives, is an absolute necessity. On level 5, controlling prepares and supports decision-making, which is done by division management. Also implementation is an issue for division management. Controlling can provide support when needed but does not play any major role. Level 6, supervision and analysis of deviations are core elements of controlling[1]. Supervision can appear in three ways: 1) check of assumptions: this serves to assess the correctness of the basis for decision-making, given changing conditions, 2) check on results: this is necessary to (also intermediately) compare budgeted values to actual values and to identify deviations, and 3) check on processes and conduct: this confronts the methods used in the planning process and the actual decisions and implementation with the intended processes and conduct. The analysis of deviation fulfils different functions: early warning on deviation of plans, allowing for timely and focused adjustments, support for coordination, motivation and evaluation of employees, clarification and reduction of weaknesses in the planning process, and connection to and input for following subsequent planning processes. All outcomes of these levels should be presented by the controlling function so as to achieve maximum impact.

b) Focus on business planning

A central element in controlling is business planning. Planning contributes in three ways (Johnson & Scholes, 1986, p.30): 1) assisting in the adaptation of the organisation to its environment by means of monitoring changes in the environment, formulating environmental and strategic scenarios, 2) providing an integration role in an organisation in the sense of acting as a communication channel and 3) providing a control mechanism to monitor performance of (parts of) the organisation against priorities. Planning can be done in three ways: 1) top-down, 2) bottom-up or 3) a combination of these two (the so-called counter flow process) (Schierenbeck & Lister, 2001, p.38ff)[2]. Planning takes place along different principles. Schierenbeck & Lister (2001, p.39ff) distinguish between strategic and operative planning, revolving planning, flexible and elastic planning, and avoidance of manipulation. Table 31 shows how strategic and operative planning differ.

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[1] As planning is future-oriented, there is a need to control business developments in current conditions. Without this check, planning might base itself on false starting points.

[2] In the first approach, top management sets the corporate goals, which are translated down in the organisational hierarchy. The second approach is characterised by the aggregation of division or divisional plan into a corporate plan. In the last approach, top management sets some preliminary goals after which divisions and divisions can modify these goals. Top management finally decides on the end result. The counter flow process overcomes disadvantages of the first two approaches, as every manager should plan his activities for which he is responsible and manage integrate planning on subordinate levels, as planning should result in a division of labour and should be delegated in order to use the present knowledge in an optimal manner, and as development of plans should be separated from the coordination, integration, decision and implementation of plans.

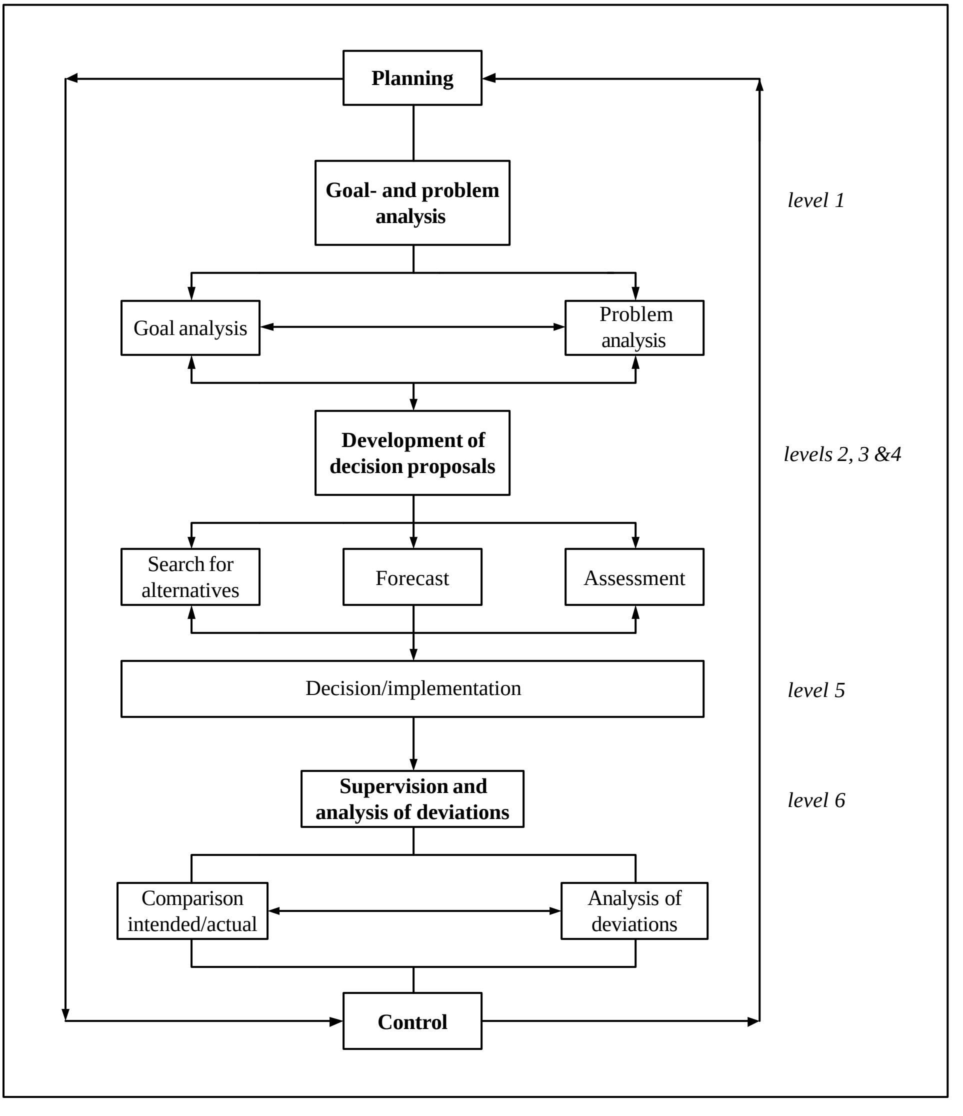

Figure 33: Process functions in controlling

Characteristic	**Strategic planning**	**Operative planning**
Hierarchical level	Focus on highest management level	Involvement of all levels with focus on middle management levels
Uncertainty	Larger	Smaller
Type of issues	Mostly unstructured	Well-structured and often repetitive
Time horizon	Mainly longer-term, but short- and middle term possible	Mainly short- and middle term
Information needs	Primarily external	Primarily internal
Alternatives	Wider range	Smaller range
Magnitude	Concentration on single important issues	Comprises all functional areas and integrates all piece plans
Level of detail	Broader and less detailed	More detailed

Table 31: Characteristics of strategic and operative planning

Revolving planning, also known as rolling forecasting, integrates two important planning elements: 1) the need for a forecast, which on an ongoing basis only changes in so far as circumstances demand, and 2) the integration of partial plans into an aggregate plan. In revolving planning, the time horizon stays constant as time progresses. At any point in time there is a plan looking into the future for a fixed time horizon. *Flexible and elastic planning* takes into account the possibility that reserves might be needed. Also, decisions of an irreversible nature are being scrutinised. Further, a decision tree can be designed dealing with possible decisions and possible outcomes. This implies continued flexibility when implementing the plan. *Avoidance of manipulation* becomes important when departments or individual managers try to secure their personal interests in the planning process: this can have an adverse impact. In order to avoid manipulation different measures can be taken (Kormann, 1974): analysis of interests of subordinate levels, standardization of planning and control systems, implementation of comparisons, development of alternatives, emphasis on reports on causes in stead of on effects, separated budgeting and approval permission in case of changes, continuous forecasts of budget deviations, creation of decentral controlling units reporting to a central controlling unit, analyses of profit potential of divisions, management audits, distribution of reporting and control responsibilities over independent departments, and complementing written reports with verbal comments.

c) Notes on budgeting

Taking financial goals to a shorter term, we arrive at budgets. Budgets, amounts for revenues and/or costs, which are fixed for an organisational unit for a period of time, form a guideline for decisions and activities of organisational units (Schierenbeck & Lister, 2001, p.59ff). General goals for budgeting are to early identify and analyse deviations of the plan, to take corrective action to re-orientate towards the plan, to manage employee behaviour, and to generate a fixed and accepted benchmark for performance measurement. Budgeting therefore, fulfils different functions: coordination of organisational units, planning to realise strategy, motivation as a managers have room to manoeuvre within the budget, allocation of resources, goal-setting function, launching of activities, and controlling as a budget allows for analysis of deviations. Budgeting can be successful if the results of the process are in an acceptable proportion to the efforts, if the contents remain consistent with corporate goals, and if the budget does not lead to wrong decisions. In order to achieve this goals should be agreed upon, priorities should be clear, budgeted costs should be manageable by the corresponding manager, who should be responsible for the budget, and budgets should remain fixed as long as basic assumptions do not change.

II. Performance measurement

1. Corporate centre costs and revenues

a) Nature and optimisation of corporate centre costs

In the corporate centre we know three kinds of costs: 1) costs for shared services, 2) costs for value added activities, and 3) costs for the core function (see also 2.B.II.1.b). The latter is often called overhead cost, as they are not directly linked to the production of (end user) services and which can only be allocated by a key which in itself also is not related to the production of (end user) services (Schierenbeck, 1997a, p.385). Reducing corporate centre costs can be difficult as corporate centre services are often of an intellectual nature, have a high level of complexity and are non-repetitive; also, when corporate centre departments have no comparable external market, there will be no competitive pressure to keep costs low; last but not least does resistance exist with corporate centre managers, often based on historical issues, bad experiences or overrating of their own capacities (Schierenbeck, 1997b, p.555ff). This implies that besides corporate centre controlling, extra measures are appropriate: 1) general cost awareness and a continuous overhaul to keep structures lean, 2) comparison of resource use in the corporate centre and divisions[1], 3) continuous process improvements, 4)

[1] Cole (1995, p.43ff) distinguishes between several approaches:

periodical check on the economics of in- and outsourcing, 5) implementation of standardised relationships, and 6) continuous activity analysis (see Figure 34). The corporate centres of companies that thought cost-effectiveness needed improving in many areas were, on average, around 2.5 times larger and those that need improving in some areas around 1.8 times larger than those that were rated *good* in most areas (Young et al, 2000, p.46). However, this relationship does not necessarily imp ly that larger corporate centres are less cost-effective. It may be that corporate managers are conscious of the high staffing in their corporate centres and infer poor cost-effectiveness. To have an idea of how substantial corporate centre costs can be, we use the survey conducted by Young et al (2000). They found the costs a percentage of turnover as shown in Table 32[1].

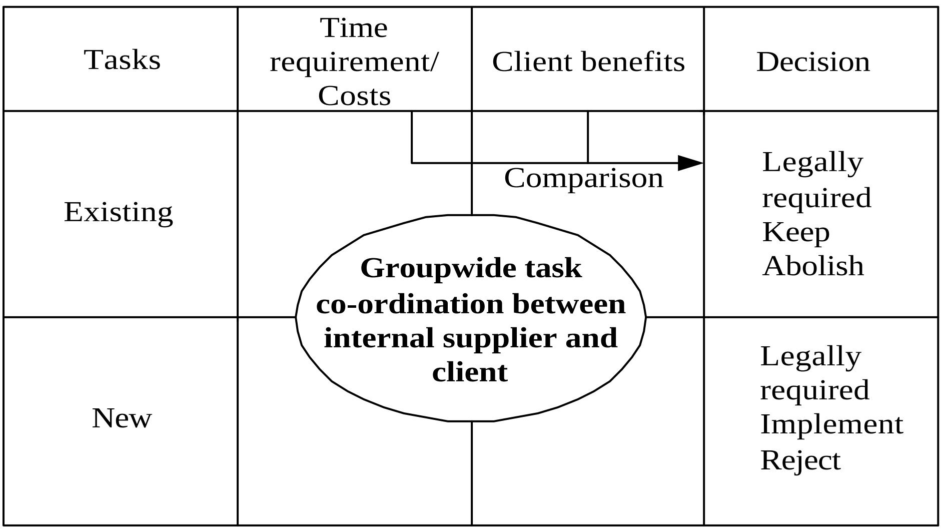

Figure 34: Continuous task analysis

- Historical averaging: this is used when the one wishes to avoid disturbing the workers at their stations or when there is a only a need for information based on historical relationships; it involves comparing relationships of previously recorded data in order to draw inferences on the measurements of tasks
- Self-logging or tim e ladders: this method relies on the workers to account for their individual time
- Relative values: here task or activity values are assigned by relative weight to one another; usually the lowest time is assigned a weight of 1.0; the weights are determined through a one-time analysis
- Work sampling: this is the process of surveying the work distribution through a form of sampling, such as randomly spaced visits; this is most useful in sorting out multiple task times in a work unit
- Stopwatch: standard times may be developed using a stopwatch; sample observations are made and tasks are timed
- Predetermined time standards: these are defined as the arrangement and classification of movements with the assignment of associated time values.

[1] Rent included.

Country	# of companies	Cost as % of turnover lower quartile	median	upper quartile
France	15	0.67	1.31	2.74
Germany	13	0.40	0.60	1.18
Netherlands	31	0.42	0.71	1.27
United Kingdom	50	0.37	0.65	1.11
USA	50	0.78	1.47	3.35

Table 32: Corporate centre cost as percentage of turnover

Making it tangible, we show the cost per corporate centre staff member in Table 33[1].

Country	# of companies	Cost per corporate centre staff member (kUS$) lower quartile	median	upper quartile
France	15	180	241	446
Germany	14	135	234	321
Netherlands	31	127	177	234
United Kingdom	50	141	224	293
USA	50	125	209	340

Table 33: Costs per corporate centre staff member

Caution must be expressed: it turns out that there does not appear to be any support for the idea that corporate centre with fewer staff typically has greater financial success. The corporate centres of companies that had profitability and shareholder value return above the average for their country were, in terms of staffing, around 20 percent larger than those of companies with below average profitability. Young et al, 2000, p.47)[2]. Different ways to optimise corporate centre cost are *overhead value analysis* and *zero-based budgeting* (Schierenbeck, 1997b, p.559ff, Voegelin, 1999, p.233ff). The first method is aimed at creating transparency in the costs produced and the required services and the potential mismatch between those two. This transparency then can lead to a decrease in costs[3]. Note that this is a one-off exercise and might therefore be disruptive for the future[4]. The overhead value analysis results in less bureaucracy, increased

[1] Note that these numbers do not say anything about the distribution of these costs.

[2] Caution is appropriate, as although the evidence suggests that corporate centre's size may be positively associated with both profitability and shareholder return, the statistical analyses do not demonstrate a causal link. It may be that companies with more corporate centre staff are more successful at creating value, or that companies with better financial performance find it easier to live with larger corporate centres.

[3] Roever (in Voegelin, 1999, p.233) estimates cost savings between 10 and 20%.

[4] The exercise consists of three phases: the *first* phase consists of making a catalogue of present services including their frequency of use, the effort for producing them, prices, and end users. In the *second* phase, the

motivation of participants, increased transparency, transfer of knowledge between divisions, and collection of ideas for improvements other than cost savings[1]. Zero-based budgeting also forms a fundamental way of analysing corporate centre cost. First, departmental goals are set, after which resource allocation takes place. In the allocation process costs get great scrutiny, which may lead to decrease of spending levels. As this is a recurring analysis, which is also broader than overhead value analysis, zero-based budgeting is a more fundamental approach. Transparency and the focused goals are other advantages. Difficulties could include lacking employee motivation, underestimation of the effort needed to explore alternatives and the approximation of cost increases when services have to change.

b) Asset and Liability Management

The corporate centre should house a group treasury function, as part of the group's risk management efforts (Schierenbeck & Wiedemann, 1995, p.4). We can distinguish between the management of the balance sheet structure, influenced by market conditions and the maximum acceptable risk, and the trade function, delivering market information and transaction services (Schierenbeck & Wiedemann, 1995, p.16). Group treasury fulfils the following functions (Schierenbeck & Wiedemann, 1995, p.5ff): 1) transformation: focus on transformation of currencies, durations and interest rates, 2) pricing, setting of prices for financial resources allocated to divisions. By using opportunity costs, a comparison can be made between a client trade and a trade in the capital markets, 3) trade, financial assets are short term traded for the bank's own accounts, which are separate from client accounts, 4) liquidity management, aim is to be able to fulfil (short-term) payment obligations by creating sufficient liquidity buffers, and 5) coordination, focus on the necessity of the integrated management of the treasury function. To fulfil these functions, the group treasury function should cover the following activities: oversight of the group's balance sheet structure and liquidity management, and execute capital market operations for the group's balance sheet. However, group treasury operations can also include daily clearing of payments, daily capital market operations for clearing and arbitration, and trade in financial instruments. Given the complexities in and changes of the capital markets, it is useful to form an asset and liability committee in which matters of more fundamental balance sheet structure are discussed (Schierenbeck & Wiedemann, 1995, p.18)[2]. The controlling department analyses the treasury risks and decides on the valuation methodologies. The

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producer makes suggestions for cost savings. These suggestions should yield substantial savings and its implementation should be time-bound. Phase *three* consists of the assessment and ranking by participants of the proposals and the expected yield.

[1] Of the cost savings, the largest part (85%) is achieved on human resources.

[2] Topics can include the prevailing structures on the capital markets and the expectation on how they will develop, an assessment of the chances and risks of changing capital markets for the firm, and the development of correcting measures, which will be implemented by appropriate departments.

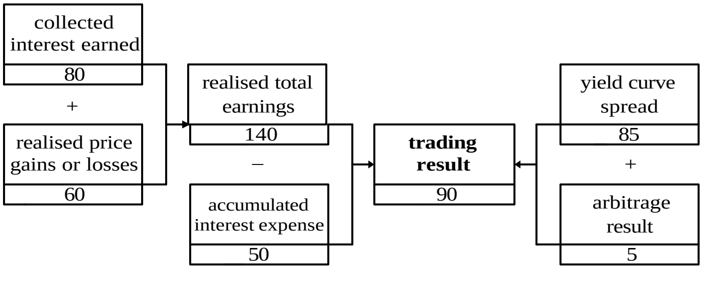
results of the asset and liability management function is the sum of the treasury result, the trading result and other results, as shown in Equation 5 (Schierenbeck, 2000b):

Treasury result = earnings from yield curve spreads – direct cost
Trading result = profit contributions trading – direct cost
Other result = profit from contributions of fixed and financial assets – direct cost
Total is Result Asset and Liability Management function

Equation 5: Asset and Liability Management result

As the treasury manages the financial conglomerate's capital , it is clear that substantial results can be achieved with this function. These results should be reported transparently so they cannot be mixed with results from client-driven trading and with irrelevant corporate centre cost. The treasury result can be calculated as in Figure 35:

Yield curve spreads from maturity transformation
+/- present value of yield curve spread after the hedge of all open positions
+/- changes in present value of interest spread after the hedge of all open positions
+/- currency transformation yield spreads
+/- interest spread resulting from issuing transactions
- direct cost of asset and liability management
= **Treasury result**



Interest spread on equity holdings
+ interest spread on fixed assets holdings
- negative spread for non-triple A banks (as difference between triple-A interestrates and the banks own rate)
- direct administration cost incurred for non-customer business positions
= **Result from other corporate centre resources**

Figure 35: Detailed calculation of treasury result

c) Direct measure of corporate centre value

Seeing the corporate centre as a profit centre, with allocations and ‘real’ profits as revenues enables to calculate value creation in a direct manner as discussed in paragraph 1.C.I.1.a (see also Equation 2). The corporate centre would have an own balance sheet and profit and loss account.

2. Benchmarking the corporate centre

The goal of benchmarking is to have an instrument to measure (improvements in) performance and to identify problem areas when goals are not reached. Benchmarks can be used statically, when the benchmark is used for a specific point in time, and dynamically, when a benchmark is used over a time period. Trends can be discovered when dynamic benchmarks are used. Often, benchmarks are based on financial ratios, derived from the management accounts. However, benchmarks can be derived from financial as well as non-financial information and can or even should be a result of combining the dimensions of the Balanced Scorecard (see also paragraph 1.C.II.3) reflecting strategy (Kajüter, 2000, p.113). Vague benchmarks open the way for internal politics and should be avoided; better are transparent objective or agreed upon subjective benchmarks[1]. Due to the lack of reliable data and the differences between firms comparisons prove difficult. Benchmarking against theory and models might be the only possible way. For financial conglomerates it is not important that they reach the benchmark, but that they understand why they differ from the benchmark, pass judgment t what extent that variation is justified and which, if at all, corrective actions should be taken. In benchmarking against other corporate centres, staffing numbers may be more appropriate than benchmarking corporate centre costs. Because of the relationship between people and corporate centre cost, policies and practices in regard to staffing have a direct bearing on corporate centre costs[2].

[1] As the Balanced Scorecard is different for different levels in an organisation, benchmarks are different as well. Requirements on benchmarks include consistency and applicability over time, comparability with best practices of internal and external service providers, measuring the intended effect (Burchard & Von Mende, 2001, p.480), and a link to the incentive sy stem to support motivation. Benchmarking can be done on different levels: characteristics of corporate centres as such can be compared (as done by Young et al, 2000); core, added value or shared services can be compared, and individual departments, processes and services can be compared. The benchmarking can take the form of comparison with other financial conglomerates; this will be increasingly possible as more financial conglomerates move towards the same structure, with other conglomerate firms, and wit h outside service providers, comparison to itself in past situations, or against models and theory.

[2] Accurate cost figures may be more representative of true corporate centre activity given that highly qualified staff cannot be distinguished from lower gr ade support staff. Staff numbers though, take less to identify and are easier to check that they are accurate and have been gathered in a standardised way. Also, it is easier to provide detailed breakdowns for different areas of the organisation (Young et al, 2000, p.21).

3. Non-financial performance measures

Non- or part-financial control measurements compare outputs to a predetermined measurement scale and focus on errors and shortfalls against goals. Ideally, control measures should be objective, complete and responsive; a measure is objective when it is independently verifiable, complete when it captures all relevant actions or behaviours, and responsive when it reflects the efforts or actions of the individual being measured[1,2]. These attributes are seldom achieved. Figure 36 summarises the major dilemmas inherent in designing measures for motivational purposes. Objective measures provide clear guidelines about what outcomes are desired. Because objective measures are derived from known formulas, there is little ambiguity about desired results. From a motivational perspective objective measures reduce the risks of perceived unfairness. Subjective measures rely on the personal judgment of superiors and will be effective motivators only if the superior is capable of making an accurate judgment about the actions of the subordinate and only if trust between superior and subordinate is high.

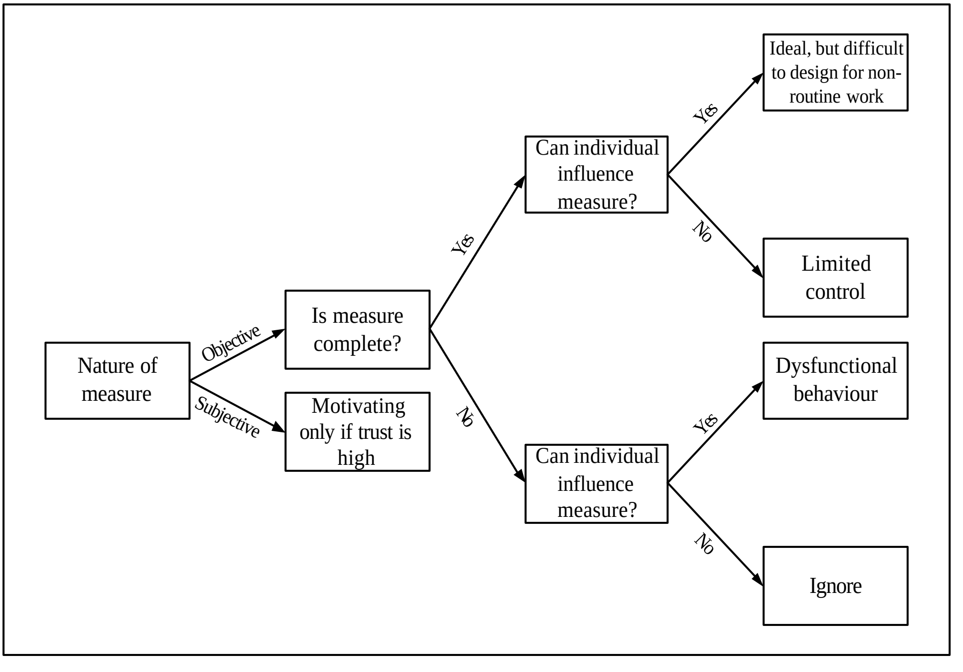


Figure 36: Characteristics of control measures

[1] Measures can be based on nominal, ordinal, interval and ratio scales.
[2] In fact, control systems are often negative feedback systems (Simons, 1995, p.75ff).

Measures may also vary in their degree of completeness. Incomplete measures can lead to dysfunctional behaviour. At the same time, the more complete the measure, the greater the chance that it is not responsive to individual efforts. Using this measure, managers may feel that doing an outstanding job will not have a noticeable effect on *corporate* performance. Objective, complete, and responsive measures can be achieved for lower level jobs where complexity, trade-offs, and uncontrollable events are at a minimum. For higher-level managerial jobs, however, finding the right balance between objectivity, completeness, and responsiveness is more difficult. Failure to strike the right balance can result in limited control of important processes, dysfunctional behaviour on the part of those being measured, and disregard for the measure altogether.

III. Allocation of corporate centre costs

1. Basis of cost allocation

a) Practice of cost allocation

Given complexity, no cost allocations would be easier but would result in management accounts not portraying true economics. That the practice of allocations, especially for shared services, is widespread. Figure 37 shows this (Young & Goold, 1999, p.22)[1].

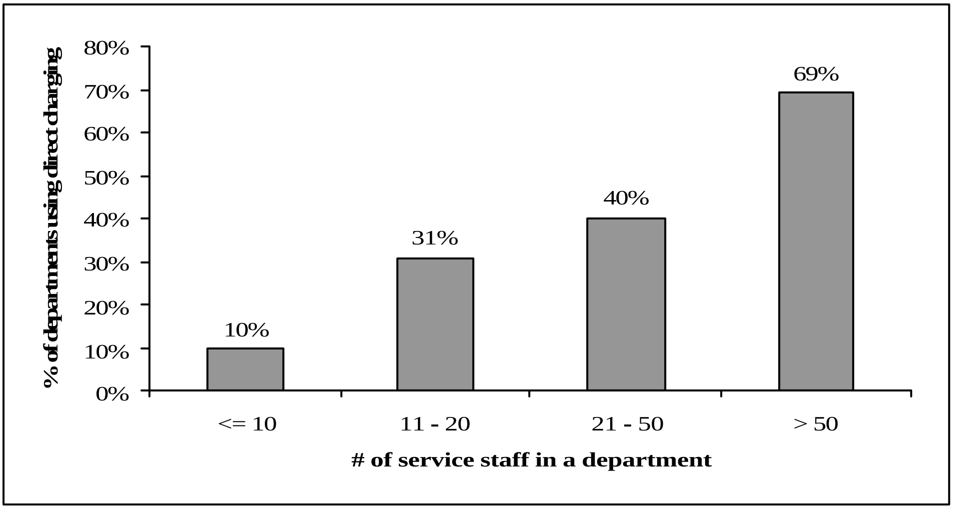


Figure 37: Direct charging versus number of staff[1]

[1] As measured in conglomerate firms in the United Kingdom.

Motivation for allocation \ Companies allocating	all cost (%)	part cost (%)	no cost (%)
Performance evaluation	57	23	20
Cost-based pricing	49	15	36
Decision analysis	43	21	36
Financial reporting	48	21	31

Table 34: Percentage of firms allocating corporate centre costs[2]

Fremgen & Liao, (1981, p.41) found that corporate centre cost allocation for performance evaluation was the most important motive (see also Table 34). In surveying managers for their motives on cost allocation, Atkinson (1987) found the results as show in Table 35[3].

Primary objective	Respondents (in %)
To motivate managers and employees	42
To make economic decisions for resource allocation	32
To justify costs or compute reimbursement	19
Other	7

Table 35: Motivation for cost allocation

b) Allocation for decision-making

Further on internal corporate decisions, Shubik[4] (1985, p.89) suggested a partial list of relevant decisions that might be aided by an appropriate allocation procedure. They

[1] E.g.: 40% of corporate centre departments uses direct charging although departments have a number of service staff of 20 to 50.
[2] E.g.: if the motivation for allocation is performance evaluation 57% of respondents allocate all costs
[3] This matches with what Horngren & Foster (1991, p.458) define as the purposes for cost allocation: to make economic decisions for resource allocation, to motivate managers and employees, to measure income and assets for reporting to internal and external parties, and to justify costs or compute reimbursement.
[4] As an analogy, in terms of profit allocation, Shubik (discussed in Young, 1985, p.40ff) suggested that an allocation scheme should provide incentives for joint action, which would maximise firm-wide profits, as the actions taken by one division can affect the profits, realised by others. In addition, given the level of autonomy assumed by Shubik, each division participating in the joint activity should be allocated profits at least as large as it could earn independently. He stated the following properties:
1. The profit allocated to a given division depends only upon the various profits which can be earned by all possible combinations of one or more divisions acting in unison (called domain axiom)
2. The allocated profit depends symmetrically upon all divisions (called symmetry, anonymity or fairness)
3. The procedure allocates all profits earned by the firm
4. A division whose presence adds nothing to the profits of any coalition should be allocated no profit (called dummy axiom)

were: decision on major investment, liquidation of a department, abolition of a product line, introduction of a new product, other innovations, the merger of several departments, the splitting of a department in several entities, pricing, purchase of raw materials, and sales of final products.

c) Criteria for allocation

Given motivations, a criterion must be chosen. Horngren & Foster (1991, p.460) and Fremgen & Liao (1981, p.47) offer six criteria: 1) cause-and-effect: using this criterion, managers identify variables that cause objects to incur costs; cost allocations based on this criterion are likely to be most credible, 2) benefits received: using this criterion, managers identify the beneficiaries of the outputs of the cost object. The costs of the cost object are allocated among the beneficiaries in proportion to benefits received. The rationale behind this allocation is the belief that some charged divisions benefited more from delivered services (such as advertisement) than others, 3) fairness or equity: this criterion can be achieved where objective data is at hand and the problem is to devise an appropriate formula for making an allocation, or with a procedural approach where a procedure which seems fair is used, e.g. an arbitration rule, an auction or a competitive market, 4) ability to bear: this criterion advocates allocating costs in proportion to the cost object's ability to bear them; the presumption is: the more profitable divisions, the greater the ability to absorb costs, 5) independence of cost objectives: here the allocation method should be designed so that the amount of cost allocated to one cost objective is not affected by actions or events in other cost objectives during the allocation period, and 6) neutrality: here indirect costs get allocated where the allocation methodology is the best for avoiding misleading information and thus prevent inappropriate decisions and inefficient disputes; the difficulty is that a method neutral to one decision might not be neutral to another. Table 36 shows that (Fremgen & Liao, 1981, p.48) most companies allocated based on *cause-and-effect*. In many cases costs stay in the corporate centre (see Figure 38, Young & Goold, 1999, p.23).

Allocation based on	Cause and effect	Benefits received	Fairness	Ability to bear	Neutrality	Other
% of companies	79	73	66	17	17	10

Table 36: Criteria used in choosing allocation bases

5. If two independent allocation problems are combined into one problem, then for each division the profit allocated under the combined allocation is the sum of the allocations under the two individual problems (called additivity).

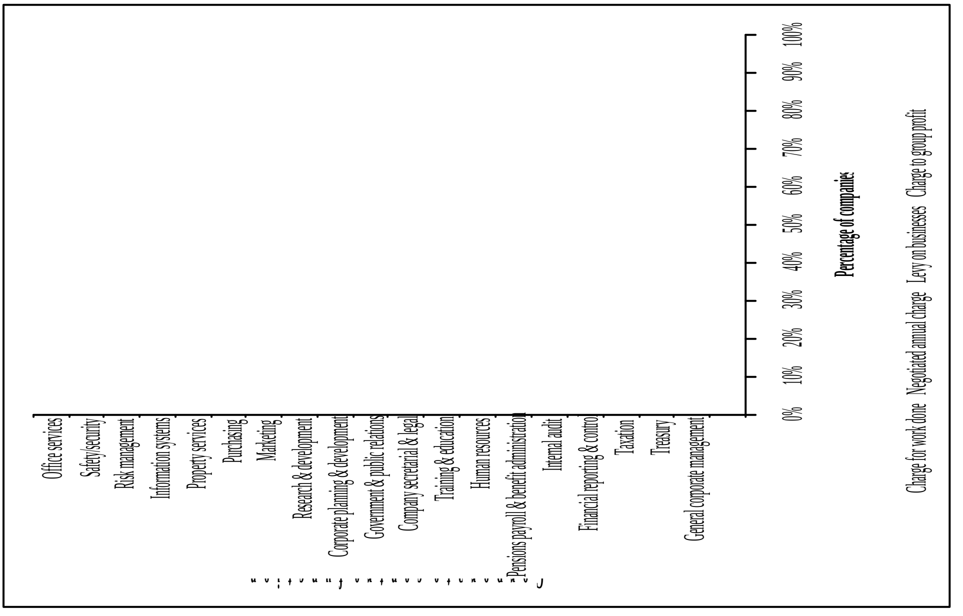


Figure 38: Charging costs for corporate centre functions

2. Application of allocation

a) Functions of allocation

Different motivations lead to different functionalities of allocations. Functions of allocation for shared services include (Voegelin, 1999, p.81): 1) transaction function, in the case of internal supply of services effecting the group balance sheet and income statement[1], 2) planning function, to supply prices to be used in planning processes, 3) management function, to set prices to be used in capacity utilisation and resource allocation, so as to fulfil organisational goals, 4) result allocation function, in order to distribute the group result to decentralised divisions, 5) motivational function, in case of prices being influential on managerial incentives, and 6) influence behaviour function, where decisions are always made in the interest of the group. The Financial Accounting Standards Board stated that indirect costs should be allocated on a reasonable basis among the divisions for whose benefit the expenses were incurred[2]. The allocation method is left to management. This means that a reporting function is introduced, which

[1] With a clear tax perspective.
[2] Statement of Financial Accounting Standards no. 14.

has effect on the value of assets and segmented income. For financial services companies only the latter applies (Fremgren & Liao, 1981, p.16). In their pursuit of different functions, some contradictory results may occur, which have implications for the design of transfer prices. First, there is no one transfer price, which can fulfil all functions, further, based on information asymmetries, setting prices for services between divisions by a corporate centre is inefficient and maybe hazardous, and because of interdependence between divisions, any one-way approach is difficult to implement. *Transaction vs. planning function*: serving the transaction function, a transfer price is supposed to reflect actual created cost, whereas in planning, a transfer price must convey information based on mid- and long-term perspectives. *Coordination vs. result allocation function*: in co-ordinating divisions it is of importance that a central governance body fixes internal service prices so as to determine divisional profits. In itself this implies a distorted business-economic perspective of a division. This is contradictory to the result allocation function for which we require true business-economic insights. In this play, the issue of information asymmetry arises as divisions actually have better information in internal services than a central body. Only in cases where that central body, e.g. a corporate centre, is market-participant one can expect a more information symmetric situation. *Motivation vs. coordination and result allocation functions*: in order for transfer prices to be motivational, they must be free from manipulation, fully linked to the service and complete. From this, it is clear that they cannot be used for coordination purposes. Insofar that transfer prices affect divisional motivation, there might be a conflict between full divisional result allocation on the one hand and having the group's goals in sight as well.

b) Distinguishing between different corporate centre costs

The costs for the core functions of the corporate centre can consists of three categories (Innes & Mitchell, 1993): 1) costs, which cannot be definitely associated with a product because their incurrence is common to a variety of outputs, 2) costs which could be directly associated with products but which, on grounds of materiality, and/or convenience, are not, and 3) costs which are directly associated with individual products but which are deemed to be more appropriately treated as relating to all output. Although Activity-Based Costing could increase transparency, allocating these costs is inevitably arbitrary (Fremgren & Liao, 1981, p.2) as this seeks to divide something, which is almost indivisible[1]. Thomas (in: Fremgren & Liao, 1981, p.10) even stated that allocating these costs is incorrigible, meaning that they cannot be proved correct or incorrect. Zimmerman (in: Voegelin, 1999, p.139) discusses two types of allocation of the costs for the core functions of the corporate centre, which can be seen as corporate

[1] Fremgren & Liao (1981) found that that the allocation bases chosen was mostly *Sales, Net Assets* and *Total Direct Costs.*

centre levy: a flat levy and a profit-dependent levy[1]. Micro-economics suggests that at the point where marginal costs equals marginal revenues, i.e. where the division works at its optimal point, a flat fixed levy for divisions does not have any positive influence for the group. Using a variable income levy for divisions *does* result in the optimal point being reached for the group. Although using the analogy of a levy makes the problem tangible, a further detailed exploration is difficult, as it does not answer the question how high this levy rate should be. With this analogy, we can see that allocating the costs for core functions can be used as management tool. Influencing divisional management may be achieved using other motivational mechanisms, and one can wonder on the effect of this tool. *Added value* costs can be allocated using a key based on divisional benefits or on fairness. Divisional managers will have ample possibility to question these costs and a business case per activity is indispensable. *Shared services* costs can be allocated using cost-based or market prices[2].

c) Price-setting for corporate centre services

A process of multiple decisions can provide a solution to the question what should be paid for corporate centre services. The marketplace provides a process for services. The nearest equivalent that can be offered in respect to corporate centre services within a company is that the total cost of any item of controllable corporate centre cost must be authorised by and charged to the person consuming that item. There are four aspects to this principle: 1) the person authorising the expense must have a free choice to use or not to use the service and to buy it internally or externally[3], 2) the person making the choice must be aware of the true cost to the company of the corporate centre service; even where company policy permits a free choice, decisions may be biased because, e.g., the accounting system does not associate all costs with the service, 3) it is difficult in most companies to establish which one person is responsible for all the expenses charged to a corporate centre service; in this accounting practice is at variance with management principles; no matter how essential it may be to account for a corporate centre service as a line item in corporate centre accounts, it is impossible to establish real control of corporate centre costs unless responsibility for charges is established, 4) if users of corporate centre functions approve, a situation will arise in corporate centre departments similar to within divisions: there will be some unused capacity. The amount and consistency of idle time in a corporate centre department will reveal the extent to which its activities are economically justified. This may indicate to

[1] For further in-depth treatment of allocation of core costs we refer to Biddle & Steinberg (1985) and Moriarity & Allen (1991). Moriarity offers a template to use in spreadsheet software, available at http://faculty-staff.ou.edu/M/Shane.R.Moriarity-1/dwl/AllocTem.xls (dated 1999).
[2] Canals (1997, p.292) states though that a critical aspect of a financial conglomerate is setting internal transfer prices for the services provided between divisions and the corporate centre.
[3] It must be clear to division managers that they have such a choice; they can apply the same methods of cost reduction in corporate centre areas that they on their direct costs.

management that provision of a service by a permanent internal organisation is not warranted. Corporate centre costs, which are charged to profit centres on the basis of actual use can meet acceptance relatively easy, provided, however, that the charge receiving manager in fact has complete control over such use in the same way he does over other costs. If he is not equally free to use/not to use competing outside services, any responsibility attributed to him for corporate centre costs is fictional to a degree. In choosing a specific internal service pricing method, the following components play a role (Voegelin, 1999, p.90): 1) strategic: what autonomy divisions have to participate on the external market, 2) market: does a complete market exist for specific services, 3) implementation: how difficult is it to install a infrastructure-supported process, 4) organisation: what are dependencies between profit centres, and 5) functional: what goals are to be achieved with internal service pricing. These different components lead to using different prices, as shown in Table 37 (Voegelin, 1999, p.84).

Orientation / **Procedure**	Cost-based	Market-based	Benefit-based
Centrally driven	Full cost Variable cost Cost plus Marginal cost	Market price Market price minus	Opportunity cost
Negotiations between divisions with or without support of a central function	Negotiated prices, cost-, market-, or benefit prices *Or a mixture thereof*		

Table 37: Types of transfer prices

Market prices: a division can use market prices to reconstruct the external market within the firm (Voegelin, 1999, p.166ff). The functions market prices fulfil include the planning, management, result allocation, and motivation functions. Important advantages include that profit centres act as independent market participants, market prices lead to maximum profits for divisions and the group alike, market prices are objective, understandable and accepted, and market prices for internal services do not crowd out external market transactions. The divisions act in the sense that they take volume decisions as prices are set by the market and that they offer their internal services at prices set by the market. In order for market prices to be useful, the following conditions apply: there is a well-functioning market with a uniform, known price for the service, all supplying and demanding divisions must be free to enter and exit the market, and the market knows no rationing[1]. Due to practicality, market prices might prove difficult in financial services. Reasons include: univocal appearance of different substitutes is lacking, no substitute is actually in existence, difficulty in fixation of prices due to market fluctuation, and banking secrecy laws might prevent market participation. Further, market prices are only useful in perfect markets with independent market participants. As divisions are not fully independent and as the internal market is *captive,* market prices can only be used as benchmarks. It is important that prices for the services should not be higher than for comparable services in the market. Using this approach brings three advantages: 1) the internal supply of services is better/same as external available, meaning that corporate centre departments behave similar to normal market participants, 2) divisions are secured in terms of price and negotiations can focus on the quantity and quality of the services, and 3) the corporate centre function involved will limit the service production to the minimum, as otherwise overcapacity will lead to a too high cost base. *Cost-based prices:* when market prices are not realisable, cost-based methods come into sight. The basis for cost prices can be actual, normalised, or planned costs. Advantages include the ease of determination and the low effort needed as data is already captured in accounting systems.

Different cost approaches include: 1) *variable costs approach*: for internal services only the variable costs are being charged; the fixed costs stay at the supplying cost centre. This might be justified when divisions are evaluated on their profit contribution. This can lead to substantial problems in planning, 2) *full cost approach*: the charged profit centre sees the charges as variable cost; at the same time to the group these costs have components of fixed and variable cost. Advantage is that in this approach, the prices are transparent, and thereby difficult to manipulate, and relatively simple. Disadvantages include the allocation of inefficiencies and of joint costs stemming from other services. None of the functions as mentioned before are being fulfilled, 3) *no-cost approach*: services of minor importance could be supplied free of charge, thereby eliminating the possibility for profit-maximising behaviour, and 4) *opportunity cost approach*: here the price moves away from pure cost considerations. This method fulfils the management function but only parts of the other functions. In this case market-conditions are introduced in the supply of internal services while at the same time transactions only take place internally. This approach also ensures that the highest[2] payoff is realised. As the prices are dependent on volumes, they are to be set in planning processes, which in turn limits divisional freedom. *Internal service prices based on negotiations:* by having internal service prices determined by negotiations, an internal market is constructed and decentralisation is supported. The negotiation process starts

[1] When limits on supply and demand exist, the concept of *market minus* can be of use in the internal supply and demand. Here supply and market research costs should be deducted from the market price. If market prices are used, a profit margin has to be included. On a firm basis, in -/excluding profit gives a 0-sum effect.
[2] With the upper limit of that price at market -level.

when a department, which would like to be paid for internally supplied services, presents a price list to internal customers. These customers then can benchmark the prices externally and can accept or decline. A precondition is that internal customers have complete information on product-and market conditions and that market participation is possible. An independent and by all parties accepted centre for resolving issues, is necessary. In this way, the valuation of services will be more broadly interpreted if necessary. The literature is not conclusive on this (Voegelin, 1999, p.89).

3. Allocation processes

Costs can be allocated in a sequential and simultaneous way. Under the sequential process the expenses are closed out from one cost centre to another. No other allocation within the structure occurs at the time of close out. The simultaneous process on the other hand involves multiple allocations between cost centres concurrently. Under this method it is possible for a cost centre to receive an allocation from a centre that is also a recipient of its allocation. Therefore, we have different allocations at the same time; Figure 39 depicts the two systems (Cole, 1995, p.155)[1].

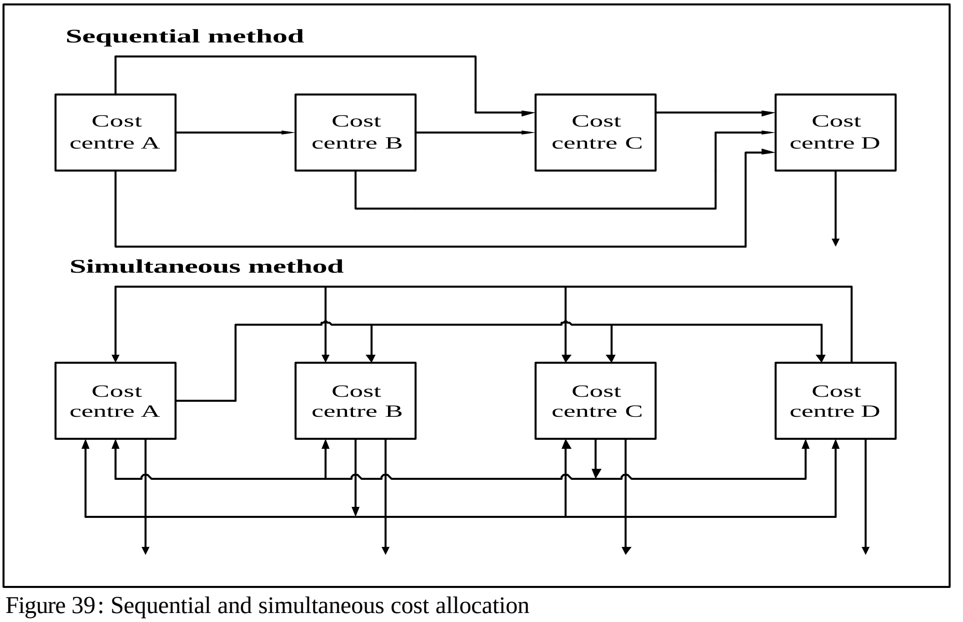


Figure 39: Sequential and simultaneous cost allocation

[1] On a transaction level the cost allocation process, according to Horngren & Foster (1991, p.461), is: 1) choose the cost object: any activity for which a separate cost measurement is desired, 2) choose the direct costs to trace to the cost object, 3) choose which indirect costs to allocate to the cost object and how to aggregate before allocation, and 4) choose the allocation base for each of the indirect cost pools selected in 3.

PART 3: DEVELOPMENT AND APPLICATION OF THE INTEGRATED CORPORATE CENTRE CONCEPT FOR FINANCIAL CONGLOMERATES

In this chapter, we arrive at the integrated corporate centre concept for financial conglomerates (ICCC). This concept is derived by harmonising theory from parts 1 and 2. We will see that the dynamics and complexities of the financial services industry, the financial conglomerate structures and the corporate intentions lead to a corporate centre; Figure 40 shows an overview of the ICCC. The result of the theoretical part of this study, the ICCC, is an addition to the literature on financial conglomerates management and suggests an approach to deal with governance issues. It forms a comprehensive benchmark for financial conglomerates' corporate centres. The ICCC consists of three interacting core elements: corporate centre nature, corporate centre management and organisation, and corporate centre economics. After having explored the ICCC, we will discuss four case studies, which are the corporate centres of the financial conglomerates ABN AMRO Bank, Credit Suisse Group, Deutsche Bank, and UBS, studied during 2000. They serve to show to what extent financial conglomerates have implemented the ICCC and to provide in a first feedback. All case studies are subject to the trends as discussed in part I, chapter A and as shown in Figure 41.

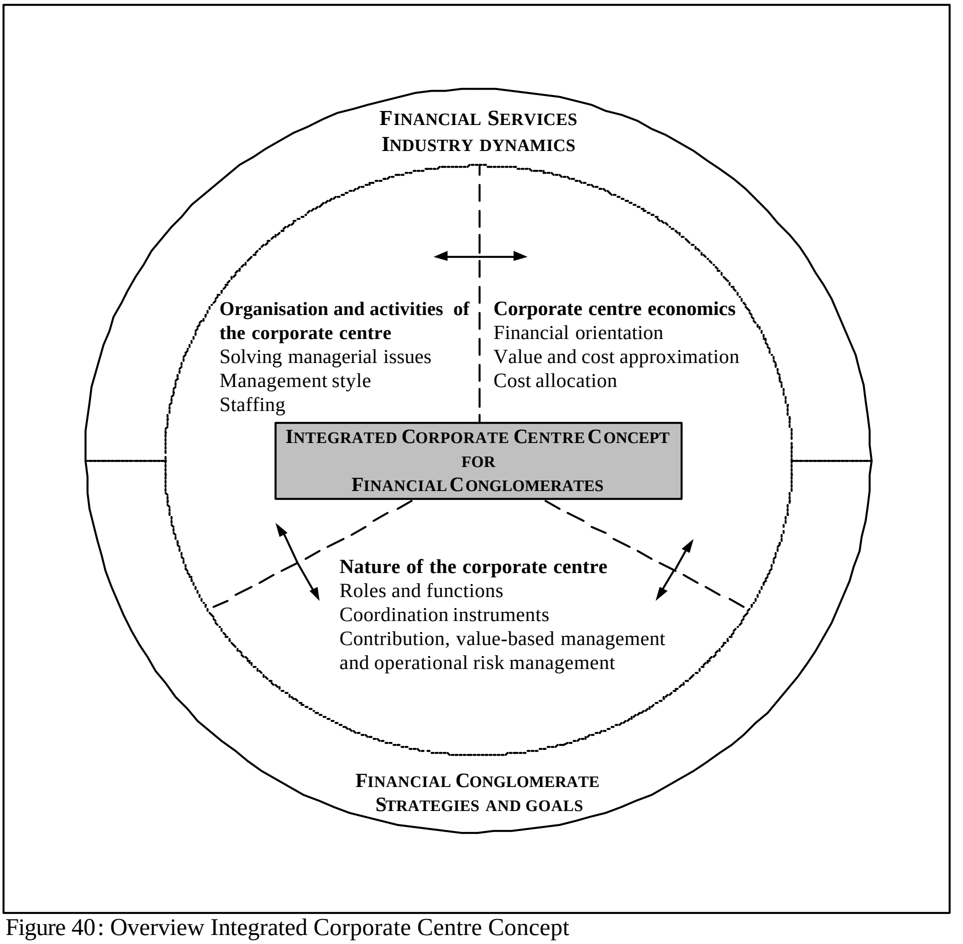


Figure 40: Overview Integrated Corporate Centre Concept

A. Derivation of the ICCC for financial conglomerates

I. The nature of the corporate centre

1. Environmental dynamics, roles and structure of the corporate centre

As per part 1, there are different forces at work in the financial services industry; Figure 43 illustrates this. These forces have consequences for financial conglomerates in the fields of strategy, governance, organisation, and product/market combinations. Although one can ask if financial conglomerates should split up under specific circumstances, we assume that financial conglomeration will be an important organisational form for the future. Financial conglomerates would be better off to give priority to the question, which competencies they already have are worth developing or acquiring, in terms of defined (geographical) markets, distribution channels and products. These core competencies have to be managed in an excellent manner, resulting in economies of scale and scope in production and consumption of financial products. New distribution channels en market strategies must be a central theme, varying per market segment, leading to a split of core competencies in organisationally independent units, each defining their specific product-market driven development.

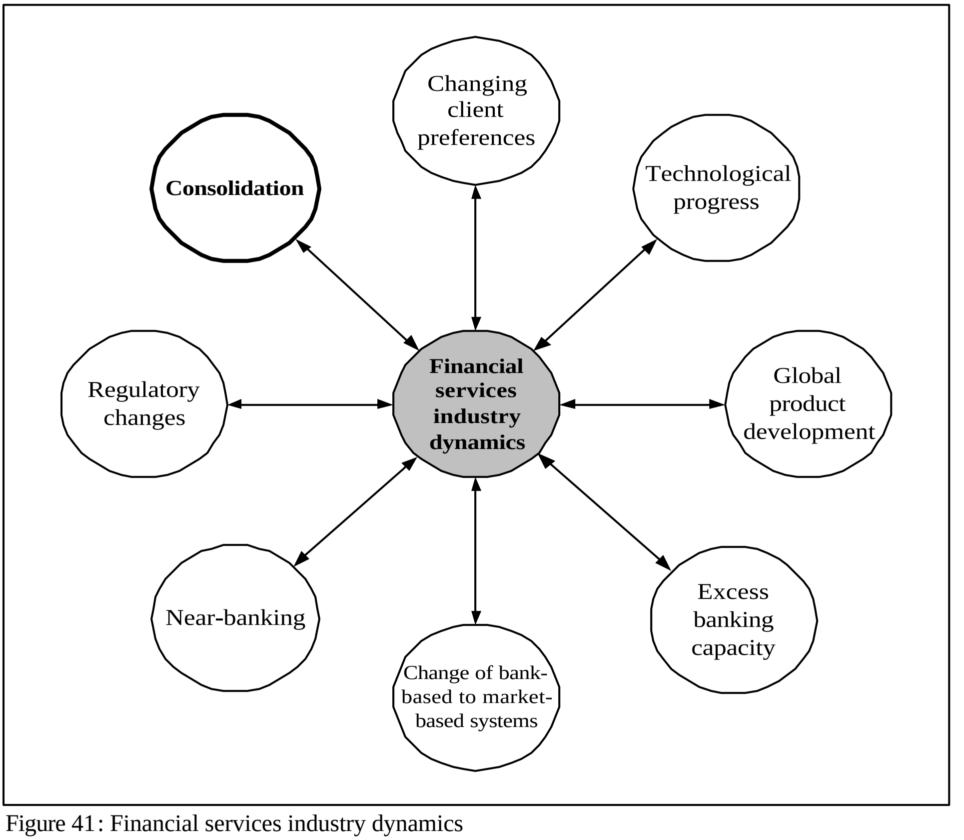


Figure 41: Financial services industry dynamics

If the corporate centre would like to enter an alliance, then that initiative should be supported (Van Wensveen, 2000, p.3)[1]. The divisions will then only take part in a

[1] E.g. for the purpose of developing competencies, increasing capital power or for defensive purposes.

merger or alliance if that make commercial sense and if the managerial ambitions are realistic. These type of alliances offer a much more flexible solution to questions of increasing scale than straight merger[1]. Now, as financial conglomerates are confronted with similar industry changes, financial conglomerates move towards the same conglomerate organisational form, revealing herd behaviour. This can be seen from Table 38[2], which deals with the divisional structure of the top 20 of US and European banking conglomerates[3]. In 9 cases out of 20, Asset Management and Private Banking share a reporting line indicating that there is one extra management layer involved; this can be explained by the affinity of the businesses or by historical reasons. Striking is that 19 out of 20 firms have the organisational structure[4], resembling divisions' stand-alone peer competitors, as shown in Figure 42:

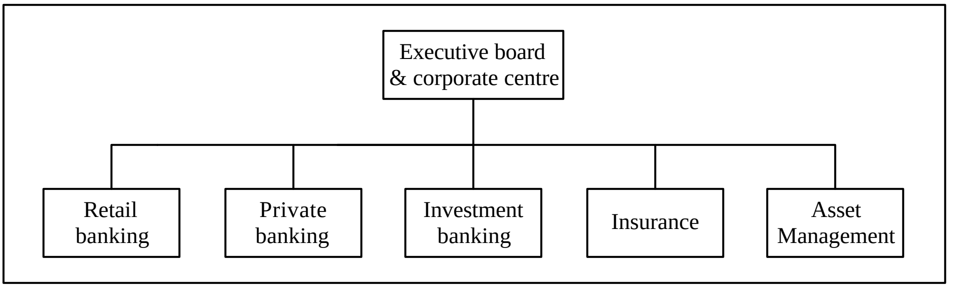


Figure 42: Example of the weak form of conglomeration

Most firms do not report separately on the existence of their corporate centre, but all acknowledge a headquarters with group functions. Other differences stem from company-specific circumstances. A longitudinal study could indicate where the organisational structures of individual firms came from, but based on the prototypes of universal banking as discussed in paragraph 1.B.I.2, we recognise a move from the three centralised prototypes (full, British, and German) to the decentralised prototype of the American variant, the weak form of conglomeration. The distinction becomes a dichotomy between stronger and weaker forms of conglomeration and the question is how strongly the divisions are bound together within the conglomerate. Partially, the move of financial conglomerates towards the weak form of conglomeration from more centralised structures results in the creation of the corporate centre as an organisational

[1] An example of this is ABN AMRO Rothschild, a joint venture between ABN AMRO Bank and N.M. Rothschild & Sons (capital market services).
[2] Based on company websites (March 2002).
[3] As measured by shareholders' equity (Euromoney, 2001, p. 140ff), with exception of large institutions only focusing on retail activities. and Japanese and Chinese institutions, which, because of historical reasons, have highly intransparent structures.
[4] ING is the exception with a primary regional focus.

unit where the executive board and specific staff departments reside. The basic premise must be to decentralise activities to divisions if they do not have a group mission. Activities with a group mission should remain in the corporate centre.

	Firm	Country	Retail banking	Investment banking	Private banking	Asset management	Others
1	Citigroup	US	Consumer Group	Corporate & Investment Banking	Private Banking (together with Global Investment Management)	Global Investment Management (together with Private Banking)	Emerging Markets
2	HSBC	UK	Personal Financial Services	Investment Banking and Markets	Private Banking (part of Investment Banking)	Asset Management (part of Investment Banking)	Capital Markets, Property Related Services, Shipping Services
3	Bank of America	US	Consumer and Commercial Banking	Global Corporate and Investment Banking		Asset Management	
4	JP Morgan Chase	US	Consumer and Commercial Banking	Investment Bank	Private Banking (together with Investment Management)	Investment Management (together with Private Banking)	Treasury & Securities Services, JPMorgan Partners
5	RBS	UK	Retail Banking	Corporate Banking and Financial Markets	Wealth Management		Citizens (USA), Direct Line, Ulster Bank
6	UBS	CH	Retail and Corporate Banking	Investment Banking	Private Banking (parts of Retail Banking and Investment Banking)	Asset Management	
7	BSCH	ES	Retail Banking	Global Wholesale Banking	Private Banking (together with Asset Management)	Asset Management (together with Private Banking)	Financial services on the Net
8	Group Crédit Agricole	FR	Retail Banking	Wholesale Banking	Private Banking (together with Asset Management)	Asset Management (together with Private Banking)	Proprietary Asset Management
9	Credit Suisse Group	CH	Financial Services	Investment Banking	Private Banking	Asset Management	
10	Deutsche Bank	DE	Retail Banking (part of Private Clients)	Corporate & Investment Banking	Private Clients (together with Asset Management)	Asset Management (together with Private Clients)	DB Services, Corporate Investments

Table 38: Divisional structure of financial conglomerates

	Firm	Country	Retail banking	Investment banking	Private banking	Asset management	Others
11	BNP Paribas	FR	Retail Banking	Investment Banking	Private Banking (together with Asset Management)	Asset Management (together with Private Banking)	BNP Paribas Capital
12	BBVA	ES	Retail Banking	Wholesale Banking	Private Banking (together with Asset Management)	Asset Management (together with Private Banking)	Industrial and Real Estate
13	Barclays	UK	Personal Financial Services	Business Banking	Private Clients	Global Investors	Barclays Capital, Barclays Africa
14	HVB Group	DE	Private Customers (together with Professionals)	Corporate Customers	Professionals (together with Private Customers)	Asset Management	Real Estate Finance, Customers and Workout, International markets
15	ABN AMRO	NL	Consumer & Commercial Clients	Wholesale Clients	Private Clients (together with Asset Management)	Asset Management (together with Private Clients)	
16	Rabobank	NL	Retail Banking	Corporate and Investment Banking	Private Banking	Asset Management	Leasing and Trade Finance, Private Equity
17	Fleet Boston	US	Consumer Financial Services, Small Business Services	Wholesale Banking	Brokerage & Wealth Management		Global Banking
18	ING	NL	Europe	Asia/Pacific	Americas	Asset Management	
19	Société Générale	FR	Retail Banking	Corporate and Investment Banking	Private Banking (together with Asset Management)	Asset Management (together with Private Banking)	
20	Lloyds TSB	UK	N/A	N/A	N/A	N/A	N/A

Table 38: Divisional structure of financial conglomerates

When decentralising, care should be taken with the levels of separateness. It must be enough to be able to compete, whilst at the same time synergies must be captured. Those operational and non-strategic activities, which would benefit from aggregation resulting in the ability to reach scale economies, should be centralised in the financial conglomerate where the centralisation conditions are the best, probably outside of the corporate centre. These shared services could compete with outside suppliers[1]. We propose to distinguish the corporate centre in two roles, but note though that corporate centre departments can show elements of both roles and even might have shared service components. These roles are *core* and *added value*, with the examples and characteristics as in Tables 14 and 15. If management thinks necessary, the corporate centre can also perform a *shared services* role. However, if there is no strategic need, then these shared services should be placed outside the corporate centre and we propose to principally exclude shared services of the corporate centre, and judge on inclusion on a case-by case basis. Figure 43 shows how the ICCC can take on various moulds.

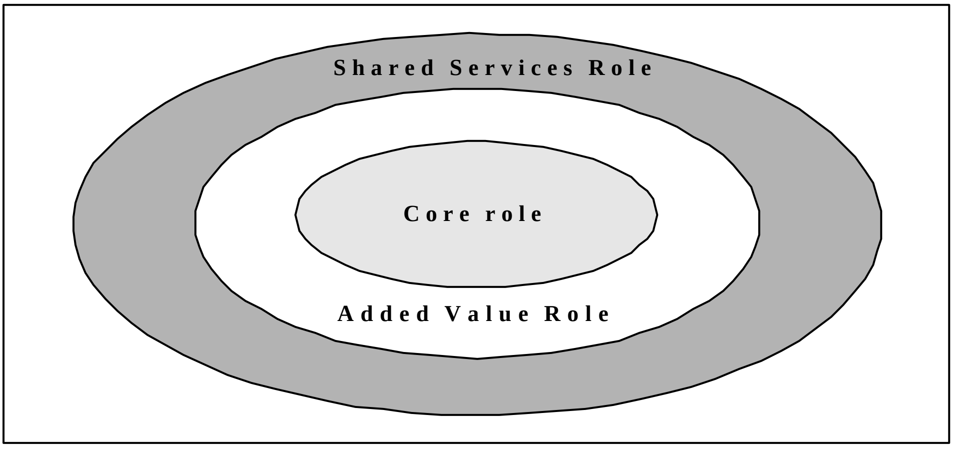


Figure 43: Mould of the ICCC

The roles as described by Hungenberg and Van Oijen & Douma can be recognised in this structure. Using this structure ensures that all corporate centre activities can be judged individually by their nature and contribution. Activities and influence of the corporate centre have to be limited to what is necessary for fulfilling the core role and what is possible, in terms of potential, for the added value role. The core role takes place in the *core* and *policy statuses*: centralisation will take place. The added value role

[1] A separate analysis would be necessary to see if outsourcing of these services could make sense in terms of product quality and costs, given that corporate centre departments often operate as monopolies. In general, the group benefits if divisions are offered fewer centralised services; this indeed implies that outsourcing centralised services strengthens group performance. However, as we have seen in paragraph 2.B.III.2.b, as outsourcing increases, the net positive effect of decreasing staff levels and t hereby decreasing corporate centre costs decreases. The net advantage comes from application of market conditions.

takes place in the *policy* and *matrix statuses*: decentralisation will take place. Influence is mostly general and less functional in nature, although the latter is not out of the scope of the corporate centre. Taking Table 24 and the theme of outsourcing, as discussed in paragraph 2.B.III.2.b, into account, we propose to form the financial conglomerate's corporate centre with functions as shown in Table 39.

Function	Group Finance & Control	Group Human Resources	Group Tax	Group Legal & Compliance	Group Audit
Main activity	Financial resource allocation and reporting	Group wide policy setting and monitoring	Tax optimisation and consulting	Group wide legal and compliance policy setting and monitoring, relations with regulatory bodies	Independent audit
Role	Core	Core	Core	Core	Core
Outsourcing possible	No	Partly	Partly	Partly	Partly
Function	Group Public Relations	Group Risk Management	Group Development	Group Marketing	Group Treasury
Main activity	Co-ordination of public and investor relations affairs	Group wide risk policy setting and monitoring	Supporting divisional synergies and generation of group strategies	Managing group brand equity	Liquidity management, balance sheet management[1]
Role	Core	Core	Added value	Added value	Added value
Outsourcing possible	Partly	No	Partly	Partly	No

Table 39: Proposed functions in the corporate centre

2. Effects of industry trends on corporate centre coordination

Changes in the financial services industry are most visible in the divisions where managers are confronted with new competitive realities. However, corporate centre

[1] As discussed in paragraph 2.C.II.1.b

managers will be confronted as well; Table 40 shows a list of functions in the corporate centre and shows which of these functions are affected by these specific environmental dynamics as mentioned in Figure 41[1]. The main lever of change for the corporate centre in financial conglomerates should be the ability of the corporate centre to support strategy and to remain cost-effective. Changes in the portfolio of businesses or changes in corporate strategy must be seen as important activities of the corporate centre. The coordination instruments of the corporate centre, as discussed in paragraph 2.A.I.2, vary by function, but we recognise that, depending on its status (core, policy, and matrix) all instruments, such as personal instruction, programs, plans, self-management, role standardisation and (sub) culture, can be appropriate. Table 41 shows which departments should use which coordination instruments.

Industry trend / Function	Group Finance & Control	Group Human Resources	Group Tax	Group Legal/ Compliance	Group Audit	Group Public Relations	Group Risk Management	Group Development	Group Marketing	Group Treasury
Qualification	Static	Static	Static	Static	Static	Dynamic	Dynamic	Dynamic	Dynamic	Dynamic
Internet banking	No	No	No	Yes	No	Yes	Yes	Yes	Yes	No
Near-banking	No	No	No	No	No	Yes	No	Yes	Yes	No
In-house banking	No	No	No	No	No	No	No	Yes	Yes	No
Excess capacity	No	No	No	No	No	No	No	Yes	Yes	No
Changing regulation	No	No	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes
Change bank/market based	No	No	No	No	No	No	Yes	Yes	Yes	Yes
Product development	No	No	No	No	No	Yes	Yes	No	Yes	Yes
Customers	No	No	No	No	No	Yes	No	Yes	Yes	No
Technology	No	No	No	No	No	Yes	Yes	Yes	No	No
Consolidation	No	No	No	Yes	No	Yes	Yes	Yes	No	No

Table 40: Industry trends affecting corporate centre departments

[1] We focus here on the specific governance role and the coordination instruments of the department (core or added value), which change because of an individual change specific to the financial services industry. It is completely clear that other (external) trends also play a role for specific departments, however, this will not lead to a change in governance responsibilities, but in a change in how activities are performed, e.g. web capabilities do not lead to a fundamental change in a governance role but does change the way a department performs an activity, i.e. in case of reporting or internal marketing of its activities.

Function	**Main activity**	**Role**	**Environmental dynamics**	**Complexity**	**Status**	**Coordination Instruments**
Group Finance & Control	Financial resource allocation and reporting	Core	Static	High	Core, policy	Culture, role standardization and plans
Group Human Resources	Group wide policy setting	Core	Static	Low	Policy	All instruments, personal instruction preferred
Group Tax	Tax optimisation/ consulting	Core	Static	High	Core, policy	Culture, role standardization and plans
Group Legal & Compliance	Group wide legal policy setting, relations with regulatory bodies, setting compliance policies	Core	Static	Low	Policy	All instruments, personal instruction preferred
Group Audit	Independent audit	Core	Static	High	Core	Culture, role standardisation and plans
Group Public Relations	Co-ordination of public and investor relations	Core	Dynamic	High	Core	Plans, goals and budgets
Group Risk Management	Group wide policy setting	Core	Dynamic	High	Core, policy	Plans, goals and budgets
Group Development	Supporting divisional synergies, generation of group strategies	Added value	Dynamic	High	Policy, matrix	Plans, goals and budgets
Group Marketing	Managing group brand equity	Added value	Dynamic	High	Policy, matrix	Plans, goals and budgets
Group Treasury	Liquidity management, balance sheet management	Added value	Dynamic	High	Policy, matrix	Plans, goals and budgets

Table 41: Coordination instruments per corporate centre function

3. Corporate centre contribution, value-based management and operational risk management

a) Investor's approach to ICCC-management

When we regard the corporate centre as a value-creating body on behalf of the investor, then we can apply the investor's view, based on portfolio management, to the financial conglomerate. Based on Figure 42, we propose to see a financial conglomerate as a portfolio of 5 stocks in stand-alone financial services company. Now, from portfolio theory we know that for a multi-security portfolio, the standard deviation and the expected portfolio return are (Elton & Gruber, 1995, p.59ff):

$$s_p = \sqrt{\sum_{i=1}^{n} w_i^2 s_i^2 + \sum_{i=1}^{n} \sum_{\substack{j=1 \\ i \neq j}}^{n} w_i w_j s_i s_j r_{ij}}$$

Equation 6: Standard deviation for a multi-security portfolio

$$R_{e,pf} = \sum_{i=1}^{n} w_i R_{e,i}$$

Equation 7: Expected return for a multi-security portfolio

Table 42 shows an example for a portfolio of 5 individual financial services stocks[1]:

		w_i	R_e	s_i	r_{ij}			
1	Insurance activities	14%	10.3%	0.628	r_{12}	0.2	r_{24}	0.3
2	Investment banking	22%	13.5%	1.156	r_{13}	0.3	r_{25}	0.3
3	Asset management	11%	9.0%	0.122	r_{14}	0.7	r_{34}	0.5
4	Retail banking	24%	14.2%	0.650	r_{15}	0.6	r_{35}	0.7
5	Private banking	29%	8.0%	0.092	r_{23}	0.4	r_{45}	0.8
		100%	11.1%	0.504				

Table 42: An example of 5 financial services stocks

1

R_e Averages of returns of a large number of comparable firms
s_i Averages of standard deviations of a large number of comparable firms
r_{ij} Assumed correlation coefficients
w_i Ratio of allocated capital to total capital as decided by investor

Together with Equations 6 and 7, the standard deviation of the example portfolio is s_p = 0.504 with an expected portfolio return of R_e = 11.138%. We call this portfolio the model ICCC-portfolio for the combination of these five stocks ($ICCC_{pf}$). If the investor chooses to buy a share of a financial conglomerate (FC) with the same characteristics in terms of capital allocation, expected divisional returns and divisional standard deviations, then the standard deviation should be s_p = 0.504 with an expected share return of R_e = 11.138%. The straight line formed by the risk-free investment (e.g. R_f = 5.750% and s_f = 0) and the ICCC-portfolio is the ICCC-line (see Figure 44).

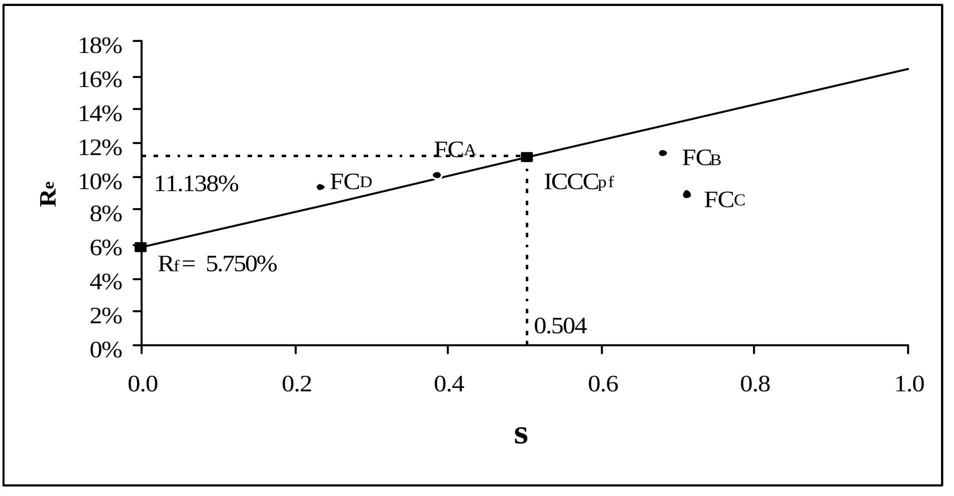


Figure 44: ICCC-line

If a share of the conglomerate plots above the ICCC-line (e.g. financial conglomerates (FC) A and D), then the investor should consider to buy the share as capital appreciation is expected; however, if the share of the financial conglomerate plots below the ICCC-line (e.g. financial conglomerates B and C), then the investor should consider not to buy the share as capital depreciation is expected. If the financial conglomerate's share plots on or above the ICCC-line, then the combination of the businesses is managed in an excellent manner. In terms of investor's preference, the financial conglomerate is a superior form over holding individual stocks and internal units, which exist just to serve the conglomerate as such, such as the corporate centre, actually create value.

b) Corporate centre contribution

Given the dynamics in the financial industry, divisions of financial conglomerates will continue to find themselves reacting imperfectly to these dynamics. The contribution of the corporate centre in a financial conglomerate therefore lies in supporting the growth of the business by repositioning (build proposition) and by reinventing the group by reshuffling of businesses with different characteristics (portfolio development proposition). Also, the corporate centre can support divisions in becoming more efficient by using resource allocation in a restricted way (stretch proposition). Perhaps the most important potential contribution of the corporate centre is the capability of the corporate centre to facilitate synergies (link and leverage propositions); by having the overview over the different divisions, the corporate centre should actively initiate synergy proposals, aimed at both scale and scope economies in production and consumption and design and deploy different instruments. Identifying and eliminating boundaries for synergy is also important (see paragraph 2.A.III.3). It is clear that the corporate centre cannot perform these activities successfully when the divisions are not motivated to pursue synergies, which requires incentive systems. The corporate centre must be highly competent and knowledgeable of the different businesses.

c) Value-based and operational risk management

As value-based management and operational risk management are becoming important issues for financial conglomerates, these issues are significant for the corporate centre in two manners: 1) insofar as the corporate centre departments perform a group task, they should promote and integrate value-based management and operational risk management in all their services offered to the divisions, and 2) the corporate centre departments themselves should implement value-based management and operational risk management in their own processes. The fact that the corporate centre does not have direct links to external customers can lure corporate centre management into the trap of false security, as a direct check might be absent[1]. Using Figure 4 for value-based management and the criteria for operational risk management, as discussed in paragraph 1.C.III.3, we can make a scoring table for corporate centre departments as shown in Tables 43 and 44, in which 5 means a high score and 0 a low score. A high score at value-based management implies that condition to be well-developed. In operational risk management, it means the opposite: it implies the need to lower that score. These tables indicate where corporate centre departments should improve on the various dimensions in order to implement value-based management successfully and to minimise operational risk.

[1] Corporate centre officials, often equipped with far-reaching authorities, can have great influence on value and risk and should be aware of that.

VBM-conditions vs. Group function	Perform ance driven	Value-based	Bottom-up and top-down	Two-way communi cations	Strong self-reinf. Process	Low cost
Finance & Control	5	4	4	4	3	3
Human Resources	2	3	3	3	4	2
Tax	4	4	2	2	3	3
Legal & Compliance	3	2	2	2	2	2
Audit	4	4	4	4	3	3
Public Relations	3	3	4	5	3	2
Risk Management	4	4	3	3	2	2
Development	2	3	1	1	2	2
Marketing	3	3	2	3	3	2
Treasury	5	4	4	4	3	3

Table 43: Example of scoring value-based management

OR-condition vs. Group Function	Sense of security	Cost	Measure problem	Mis communic.	Over reliance	Incomp. systems	Decentral.	Org. specific	Missing skills
Finance & Control	1	2	2	2	2	1	1	2	2
Human Resources	1	3	3	2	3	3	3	2	2
Group Tax	3	2	2	3	2	2	3	2	3
Legal & Compliance	4	2	1	2	0	2	1	1	3
Audit	1	2	3	3	3	3	3	3	2
Public Relations	2	2	1	2	3	2	1	1	2
Risk Management	2	3	3	2	1	1	1	2	2
Development	1	2	1	2	1	2	1	2	1
Marketing	1	2	1	2	1	2	2	2	2
Treasury	1	3	3	3	2	2	2	3	2

Table 44: Example of scoring operational risk management

II. Corporate centre management and organisation

1. Solving managerial issues

In paragraph 2.B.I.2, we have identified six problems of the corporate centre in governing a financial conglomerate. The *agency* problem between the corporate centre and the divisions can be solved using performance contracts. In these contracts, market conditions should be replicated and top management preferences can be reflected. *Moral hazard* can be avoided if the incentive structure of managers is consistently symmetrical. This can be achieved by paying positive out on and deducting negative bonuses from an escrow account. These bonuses vary with swings in the valuation of the corporate centre and the group. The *coordination* problem can be tackled by forming formal communication channels, such as committees, while at the same time adjusting the compensation systems to reflect the extra effort and result from these communications; this is also a mechanism useful for supporting synergies. Having a detailed and well-accessible information system provides a tool to deal with difficulties in *organisational design*. As the organisation structure does not vary with the environment by itself, we cannot expect that the organisation structure in itself enables solutions; the organisation structure should be empowered, i.e. give rise to initiation of the solution. In this way, it could be that managers from different departments and levels are working to solve a specific client need. Incentive systems, which take individual motivation in account should support *motivational issues*; however, the more individual the system becomes the more difficult to standardise processes. A high level of transparency ensures that *influence costs* remain limited.

2. ICCC-management style

Given 1) the industry dynamics, 2) the weak form of the financial conglomerate and 3) the focus of the corporate centre on the core and added-value role, we can now position the ICCC-management style. Using the continuum of Figure 26 between the strategic planning and financial control management styles (paragraph 2.B.II.1), the ICCC-management style should be positioned between strategic and financial control. The emphasis is on managing multiple separate profit centres, each with relatively independent responsibilities. In the strategic review process, the corporate centre can challenge divisions, especially where synergies are concerned. In this way the corporate centre attempts to add value. The planning process is focused on target agreements rather than on the means. Long- and short-term criteria ensure strong incentives for the divisions to deliver. Resource allocation is similar to the mechanisms in the capital markets. Decentralised organisation structures should overlap in the sense that committees are formed in which synergies can be explored. These committees should be chaired by representative divisional rotation (including the corporate centre). In this manner, the committee members all are responsible for realising the potential benefits. As detailed long-term strategic planning becomes increasingly difficult in the financial services industry, the focus has to be put more on the mid-term with short-term indicators. Strategy development should take place in the divisions and on a group level in the corporate centre. Although the level of detail should not be too high, the strategic plans should result in financial projections. These top-down and bottom-up processes should *interact*, but only after the first plans are formulated, and should result in a complete strategy. Divisions have far-reaching autonomy within the stated mission and central policy objectives of the group, although they do have to take into account that corporate centre functions might need certain divisional input. Controls should always be such that results can be compared to competitors and other divisions: a normalised number is necessary. In addition, for the corporate centre, benchmarking, as discussed in paragraph 2.C.II.2, should yield useful insights. Using the terminology of Campbell & Gould, we can summarize the ICCC-management style as follows (Table 45):

Key features	**Added value**	**Subtracted value**	**Pitfalls**
Separate profit centres, divisional coordination	Simplifies task Early general management responsibility		
Budgetary planning	Higher standards Challenges that won't deliver Avoids 'potholes'	Distracts from strategic issues	Encourages milking the business
Business autonomy	Advice, not instructions	No co-operation, no 'help' for divisions	Gratuitous suggestions
Long- and short-term criteria	Acceptance of longer-term investments Balanced objectives	Ambiguous objectives	Tolerance for low performers Capital rationing Uninformed in/divestments
Flexible controls	More tenacious pursuit of long-term goals More innovative, responsive strategies	Subjective assessments Less accountability	Can lead to politics

Table 45: Summary of the ICCC-management style

3. Staffing the corporate centre

The calculation model in paragraph 2.B.II.3.c gives an indication how the core role of a corporate centre can be staffed. Based on Tables 29 and 38, Table 46 shows a more detailed approximation of staffing levels[1]. Large corporate centre staffs are not generally rated as more effective than small ones. It is the skills of the staff and the value from their activities that matter more than their numbers or cost. At the same time, large corporate centre staffs are fully justified provided that they are genuinely needed to support value creation opportunities. As can be seen from and Table 47 and Figure 45, it becomes clear that, as the financial conglomerate grows, in terms of headcount, the corporate centre grows slower, which points to scale effects.

	Europe	USA	Europe	USA
Corporate centre function	Corporate centre staffing	per 1,000 fte (median)	Financial conglomerate	with 50000 fte
Group Finance & Control	3.9	6.4	193	320
Group Human Resources	2.3	0.7	115	33
Group Tax	1.0	1.2	50	58
Group Legal & Compliance	2.5	4.6	123	229
Group Audit	1.3	2.7	65	136
Group Public Relations	0.7	1.1	34	53
Group Risk Management	0.3	0.1	14	4
Group Development	0.7	0.9	37	46
Group Marketing	0.1	2.0	5	98
Group Treasury	0.3	1.3	15	65
Total corporate centre staff (fte)	**13.0**	**20.8**	**649**	**1040**
Of total fte	**1.3%**	**2.1%**	**1.3%**	**2.1%**

Table 46: Staffing per corporate centre function in a financial conglomerate

	Status	**A**	**B**	**C**	**D**	**E**	**F**
Total # fte		50,000	60,000	70,000	80,000	90,000	100,000
Total corporate centre staff (fte)	**Europe**	649	713	778	843	908	973
		1.3%	1.2%	1.1%	1.1%	1.0%	1.0%
	USA	1,040	1,144	1,248	1,352	1,456	1,560
		2.1%	1.9%	1.8%	1.7%	1.6%	1.6%

Table 47: Corporate centre' staffing in a growing financial conglomerate

[1] Based on own calculations

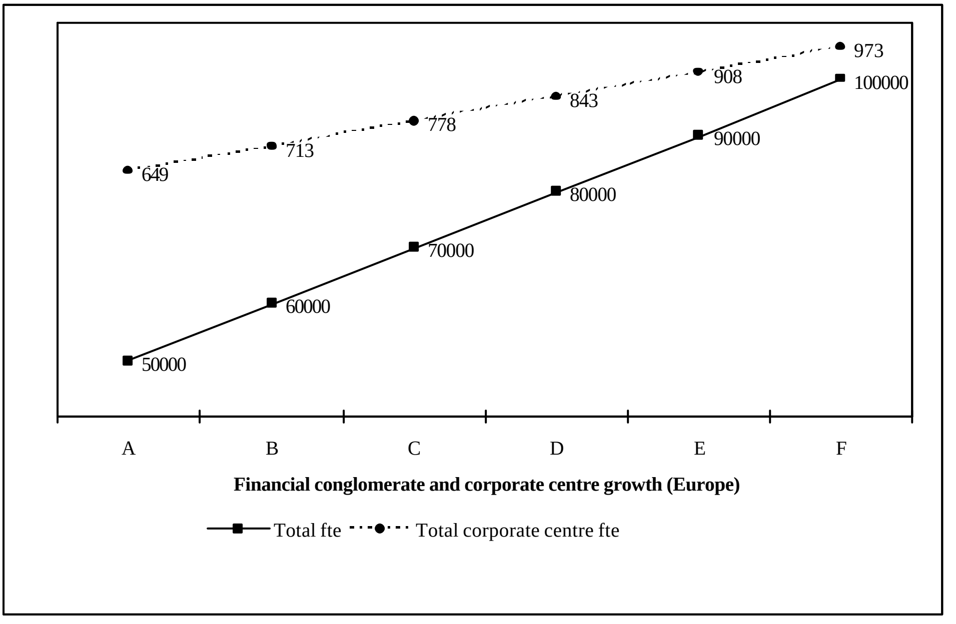


Figure 45: Various sizes in a growing financial conglomerate

III. Corporate centre economics

1. Financial orientation of the corporate centre

Financial conglomerates increasingly have more specialised divisions; this can be understood as an increase in the transparency and understanding of the level of diversification. As we saw in paragraph 2.A.I.1.b, this implies that more emphasis should be put on financial measures than strategic measures for assessing a division's performance[1]. In the continuous search for the right corporate centre, the effectiveness of the corporate strategy and the corporate centre must be assessed. Principally, the corporate centre should be managed as a profit centre. This does not mean that corporate centre departments should make a monetary profit: it means that the behaviour of corporate centre managers and staff should be modelled as if the department was a market participant in its own right. Benchmarks, the Balanced Scorecard and incentive systems can help to orientate corporate centre managers. Also, the profit centre structure ensures transparency. Cost allocations out of the corporate

[1] This does not mean that strategic considerations are unimportant; these are indeed important.

centre, as discussed in paragraph 2.C.III, can be seen as revenues. However, if revenues prove unable to calculate, the revenue side of the corporate centre department can be expressed in market-based financial or non-financial benchmarks, expressing efforts and results of the corporate centre (department) (see also paragraph 2.C.II.2). Better or same benchmark performances point to a proper relationship between cost and benefit. With reference to paragraphs 1.C.II and 2.C.I, the corporate centre should have an appropriate controlling organisation and mandate. Similar to the cost development of the corporate centre to the cost development of the financial conglomerate as a whole, if the corporate centre controller (CCCL) has the organisation and mandate, the controlling function would grow less fast than the corporate centre. This mandate should encompass 1) projections, revenue and cost budgeting, planning, investment and performance review, 2) authority in the field of information and recommendation in matters of corporate centre expense, 3) instrumental in effecting changes in corporate centre costs, 4) divisional policy, the interpreting of firm-wide plans and projects insofar as they affect corporate centre planning, and executive contact for adjudication of interdepartmental matters, 5) source of studies and analyses of more efficient ways to perform corporate centre functions, particularly in the area of overlapping procedures, and 6) enforcement of plans to reduce corporate centre costs. It is important to stress that if the controlling mandate is too narrow, the level of management support for the CCCL is too low, or if the CCCL lacks resources, effective control cannot be established.

2. Approximation of value and costs

a) The Residual Value method

Recognising the corporate centre as a profit centre allows us to estimate the necessary variables to use in the direct methods for the measurement of value creation as discussed in paragraph 1.C.I.1.b. Based on regression analysis of peer comparisons, this could be relatively straightforward but would consume quite some resources if done for reporting purposes only. If we desire to measure the value added of the corporate centre as part of the group instead of as a standalone unit, then the typical problem that revenues are lacking appears. Only the shareholder value creation of revenue generating profit-oriented units can be measured directly. This means that, from a methodological point of view, a direct calculation, such as mentioned in paragraph 1.C.I.1.b, for standalone business or otherwise revenue generating entities, is not possible for the corporate centre. We therefore present an indirect way of calculating added shareholder value of the corporate centre. We call this the *Residual Value*-method (ResVal-method) and it works as follows (see Equation 6): 1) calculate shareholder value creation per (revenue generating) division with Equation 2[1] over more than one period (leave out the corporate centre), 2) sum these values of the business divisions, 3) calculate the value creation of the group[2] as the difference in market value of the group in the corresponding period, and 4) the difference between 2 and 3 is the shareholder value attributable to the corporate centre.

$$\text{Value creation}_{CC} = \text{Value creation}_{Group} - \sum_{i=1}^{n} \text{Value creation}_{Division\ i}$$

Equation 8: The ResVal-method calculates the corporate centre value creation

In using the ResVal-method, we should calculate the value of the divisions *before* cost allocation[3] of corporate centre's core and added value roles. Cost allocation should only be done for shared services, as these should be seen as internal service providers comparable with external ones. In this way, divisions resemble their competitive peers, which also do not receive any cost allocations, as they are not part of a financial conglomerate structure. Moreover, the corporate centre does not create value without causing costs. The result is that we can completely observe the corporate centre effect: the effect that divisions are members of a group and governed by a corporate centre.

Division \ Period	Economic Profit Year 1	Economic Profit Year 2	Value creation Period 2-1	Economic Profit Year 3	Value creation Period 3-2	Economic Profit Year 4	Value creation Period 4-3
Private banking	31	33	**2**	35	**2**	38	**3**
Retail banking	12	16	**4**	14	**-2**	13	**-1**
Investment banking	37	35	**-2**	31	**-4**	26	**-5**
Asset management	8	6	**-2**	7	**1**	9	**2**
Total for divisions	**88**	**90**	**2**	**87**	**-3**	**86**	**-1**
	111%	100%	**18%**	96%	**-300%**	101%	**17%**
Group market value	**79**	**90**	**11**	**91**	**1**	**85**	**-6**
Corporate centre value creation	**-9**	**0**	**9**	**4**	**4**	**-1**	**-5**
relative to group	**-11%**	**0%**	**82%**	**4%**	**400%**	**-1%**	**83%**

Table 48: Quantitative value added by the corporate centre

[1] From paragraph 1.C.I.1.a. As an example for the value creation in Table 45 for the division Private Banking in period 1: Economic Profit = NOPLAIT – Economic Capital * RAROC = 31 = 41 – 143*7% (assumed).
[2] We assume that the group is listed as one stock.
[3] We refer to paragraph 3.A.III.3: a discussion of allo cation for *management* purposes.

Table 48 and Figure 46 show an example for a financial conglomerate[1]. Obviously, it is difficult to break an increase or decrease in market value down to individual divisions, i.e. what value is created where due to synergies; a survey under shareholders could give an indication.

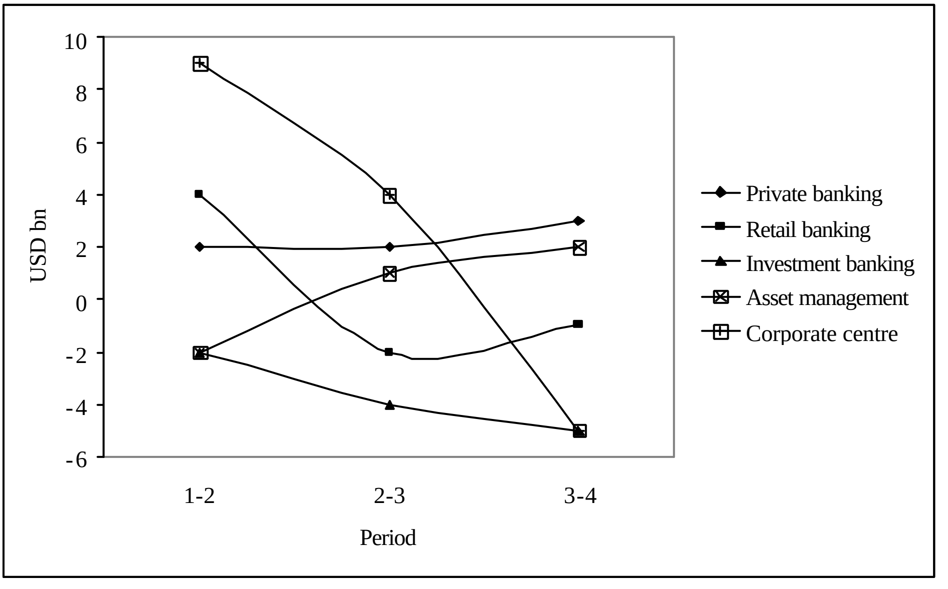


Figure 46: Divisional value creation over time

If that difference is positive, one might assume that the capital markets are judging factors such as synergies as positive. Peer comparison could give a first idea on that. The assumption is that divisions benefit from being a member of the group and that the corporate centre is responsible for the synergies: divisions by themselves, left to their own devices, would not strive for interdivisional synergies. Capital market participants, shareholders and group management should take careful consideration if the negative added value produced by the corporate centre is lower than the produced synergies.

b) Providing a cost benchmark

Based on the data in Tables 29, 33 and 39, Tables 49, 50 and 51 present benchmarks for costs levels for the corporate centre in financial conglomerates. As corporate centres in financial conglomerates vary, this benchmark can help as a first orientation.

[1] The numbers are for illustration purposes only and do not stem from any existing financial conglomerate.

	Europe			USA		
Corporate centre function	lower quartile	median	upper quartile	lower quartile	median	upper quartile
Average cost per corporate centre staff (kUS$)	142 65%	217 100%	327 151%	142 65%	217 100%	327 151%
Group Finance & Control	547	835	1,259	907	1,387	2,090
Group Human Resources	327	499	752	94	143	216
Group Tax	141	215	324	165	252	379
Group Legal & Compliance	349	534	804	649	992	1,494
Group Audit	185	282	425	385	588	886
Group Public Relations	97	148	222	151	230	347
Group Risk Management	38	59	88	11	17	26
Group Development	105	161	242	131	200	301
Group Marketing	13	20	29	278	425	641
Group Treasury	41	63	95	183	280	422
Total corporate center cost per 1,000 fte in the financial conglomerate (in kUS$)	**1,842**	**2,814**	**4,241**	**2,954**	**4,514**	**6,802**

Table 49: Corporate centre cost benchmark for financial conglomerates

	Total corporate centre cost (in US$ mio)					
	Europe			USA		
Growing financial conglomerate (in fte) - status B to F	lower quartile	median	upper quartile	lower quartile	median	upper quartile
60,000	101.3	154.8	233.3	162.4	248.2	374.1
70,000	110.5	168.9	254.5	177.2	270.8	408.1
80,000	119.7	182.9	275.7	192.0	293.4	442.1
90,000	128.9	197.0	296.9	206.8	316.0	476.1
100,000	138.1	211.1	318.1	221.5	338.5	510.1

Table 50: Corporate centre cost development in an organically growing financial conglomerate

Financial conglomerate with 50,000 fte (status A)	Europe			USA		
Corporate centre function	lower quartile	median	upper quartile	lower quartile	median	upper quartile
Group Finance & Control	27.3	41.8	62.9	45.4	69.3	104.5
Group Human Resources	16.3	25.0	37.6	4.7	7.2	10.8
Group Tax	7.0	10.7	16.2	8.2	12.6	19.0
Group Legal & Compliance	17.5	26.7	40.2	32.4	49.6	74.7
Group Audit	9.2	14.1	21.3	19.2	29.4	44.3
Group Public Relations	4.8	7.4	11.1	7.5	11.5	17.3
Group Risk Management	1.9	2.9	4.4	0.6	0.9	1.3
Group Development	5.3	8.0	12.1	6.5	10.0	15.0
Group Marketing	0.6	1.0	1.5	13.9	21.3	32.0
Group Treasury	2.1	3.1	4.7	9.2	14.0	21.1
Total corporate centre cost (in US$ mio)	**92.1**	**140.7**	**212.1**	**147.7**	**225.7**	**340.1**

Table 51: Cost example of a corporate centre in a financial conglomerate

In order to maximise insight in and control over costs, cost accounting should be done along the lines of work processes, in which value- and cost drivers are distinguished. ABC and PSDC are appropriate instruments in this respect. In revenue accounting for the treasury function, MFTP should be used. In this way, the corporate centre becomes a value- and market-oriented organisation.

3. Corporate centre cost allocation

The corporate centre has two types of roles and functions, core and added value. As the ICCC-mould in Figure 43 illustrates, shared services could be part of the corporate centre. Allocations for core functions should be seen as a corporate centre cost charge and are motivated by corporate interests. This means that corporate level management can decide how this burden is distributed over the divisions, portraying what corporate level management thinks of its efforts for the divisions but without giving the impression of an arbitrary allocation. The allocation performs the motivation and influencing functions. Criteria for the corporate centre cost charge (also named indirect cost) should be fairness, neutrality and benefits received. If this burden falls on the corporate centre, then the charge is against group profit and is not used to influence divisions. This is the easiest method but has the effect that divisions experience the corporate centre to be for free or even perceive the corporate centre to be value destroying. Allocations for added-value functions should be justified by costs incurred. The best criteria for this type of allocation are cause and effect, and benefits received. The allocation performs the result allocation, transaction and motivational functions. If they exist, shared-service costs can be allocated based on the replication of a market place. This is done to justify costs and to compute reimbursement and to make economic decisions for resource allocation. Cause and effect, and benefits received must be the main criteria. In setting prices, it is important that the divisions do not form a captive market. Market prices are the main prices used, but cost-based prices might apply. As services might only be partly available on the market, prices should reflect this part availability. Negotiated prices, containing elements of market based prices and cost based prices are appropriate here. In order to have transparency in the real flows between the corporate centre and divisions, allocations should take place in a simultaneous way without netting, as discussed in paragraph 2.C.III.3.

B. Corporate centres in four financial conglomerates

I. ABN AMRO

1. General observations

a) Introduction

ABN AMRO Bank NV (AA)[1] is a global banking group of 115,098 people (of which 33.8 percent in the Netherlands) active in 74 countries and headquartered in Amsterdam, the Netherlands[2]. For 2000, its balance sheet totalled € 543 bn, net profits were € 2.4 bn and the market capitalization was € 37.2 bn (ABN AMRO, 2001). AA, presided by the Group Managing Board (GMB), is organised in five divisions and a headquarters, which are all based in Amsterdam (see also Figure 47):

1. ABN AMRO Lease Holding, with 7,070 fte
2. Foreign Division, with 59,324 fte
3. Investment Banking Division, with 12,248 fte
4. Netherlands Division, with 26,132 fte
5. Resource Management Division, with 9,674 fte
6. Headquarters, with 650 fte.

During 2000, AA reorganised into three strategic business units (SBUs), Wholesale Clients, Consumer & Commercial Clients, and Private Clients & Asset Management, and a Corporate Centre. Goals of this reorganisation were (ABN AMRO, 2001, p.19): 1) a clearer focus in the activities and organisation, 2) to improve service to clients, 3) to increase transparency in and accountability for value creation and destruction, 4) to have managers concentrate in what they do best, and 5) to provide employees with a more challenging working environment and to offer them a corresponding compensation. Although at present AA increasingly shows a trend in the direction of the American variant of a financial conglomerate the status in 2000 was more that of a mixture of the German and British variants. This is due to changing priorities in the product and client mix and its effect on the organisation.

[1] The corporate centre of ABN AMRO Bank was studied during 2000. Dynamic as the financial services industry is, many changes took place during and after 2000.
[2] For a description of the recent history of ABN AMRO Bank, specifically the merger of ABN and AMRO, we refer to Nawas (1995).

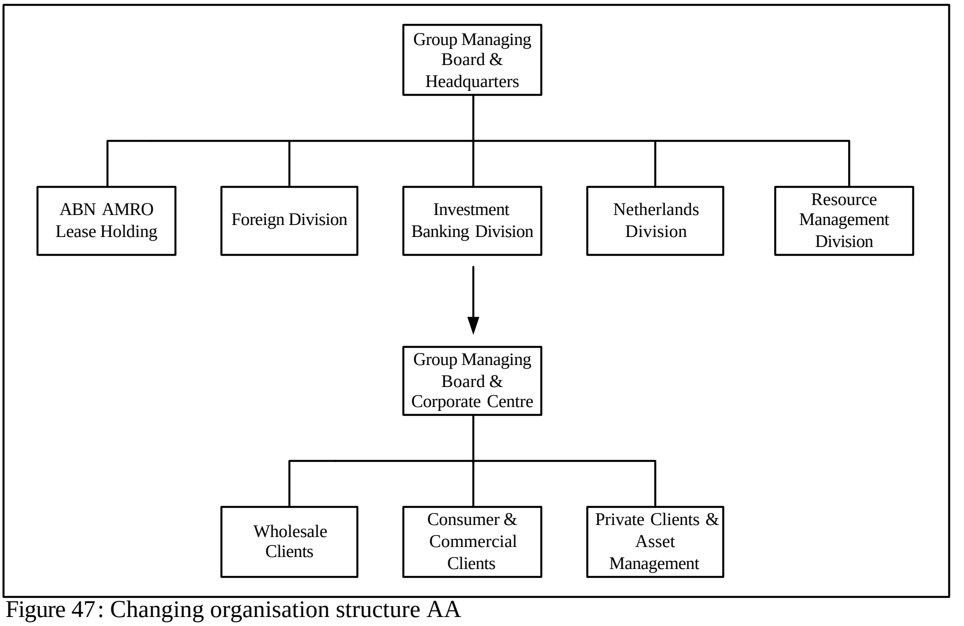


Figure 47: Changing organisation structure AA

b) Value orientation

AA recognises that there are different stakeholders, which have an interest in the development of the group's results. The emphasis on shareholder value forms the best means for a well-balanced protection of the varying interests of these stakeholders. The ultimate yardstick to measure whether AA reaches its primary goals is the total shareholder return, as measured by the increase of the share price combined with dividend payments. The program AA has chosen to realise maximum shareholder value is called *Managing for Value* (MfV) and the bank expects MvF to be fully interwoven in the corporate culture. MfV demonstrates itself in two ways: 1) economic value, as witnessed in the market value of AA, and 2) economic profit, as defined as the net profit after tax less risk-adjusted cost of capital; this is the amount of annual value creation and corresponds to the methodology of Stern Stewart, as discussed in paragraph 1.C.I.1.b. MfV is seen as a holistic approach with three fundamental aspects: organisation, strategy and finance. AA expects MfV to become *a way of life*. Capital and human resources will be allocated to activities, which offer the prospects for the best yields. AA uses MfV to improve performance, to facilitate cultural change, to improve the way the group dialogues with investors, and to improve the way the group manages itself by increasing transparency and accountability throughout the organisation (ABN AMRO, 2000). In AA, value-based management is centred around six processes (Van Dun, 2000, p.24, based on McTaggert et al, 1994):

1. Corporate governance: this involves determination of a) an organisational structure with the greatest clarity and transparency, and b) the right roles and responsibilities to achieve the highest degree of accountability for value creation or destruction. The GMB consists of members with SBU responsibilities and the Chairman and the CFO with group responsibilities. the Chairman and the CFO should: 1) make, uphold and reinforce the rules by which AA will be managed, 2) create the organisation needed to achieve AA's governing objective, 3) ensure that all corporate and business unit strategies support the achievement of the governing objective, and 4) ensure that the corporate agenda is executed. The members with SBU responsibilities should: 1) determine the highest value for their business units, and 2) implement the strategy successfully
2. Strategic planning: this involves developing strategic options and is a continuous and bottom-op process. Based on three to four year economic profit projections, the highest value creating strategy can be identified and selected. Discussion and approval of strategic plans is a responsibility of the entire GMB. After approval, a performance contract is signed that commits the SBU management to perform the plan and the Chairman, the CFO and the corporate centre fund the strategy
3. Resource allocation: the budgeting process should result from the strategic planning processes. The Chairman, CFO and the corporate centre are to decide where resources are best allocated
4. Performance management: value-based targets play an important role in performance measurement. The internal measurement of performance is the sum of all business unit economic profit. The external measurement is related to total return to shareholders
5. Management compensation: compensation should be linked to the governing objective. The GMB and Corporate Centre staff should be compensated on the basis of total return to shareholders and economic profit. SBU management should be compensated on the basis of SBU economic profit
6. Financial policy and capital structure: besides the profit and loss account also the balance sheet is important; equity use is penalised via a capital charge.

c) Operational risk management

AA defines operational risk as the risk that a loss is created as a result of ineffective or failing internal processes, human behaviour and systems or as a result of external events. Operational events such as problems with information technology, shortages of the organisational structure or internal control, human behaviour, fraud and external threats are included (ABN AMRO, 2001, p.55). Responsibility for the operational risk management is with managers and staff at all levels of the organisation. There are several coordinators for operational risk management within the bank. They provide managers and staff with policies, methods, means of support and information to improve operational risk management. Further, in 2000 a management structure has been set up to coordinate, approve and implement operational risk management. Also, an operational risk policy was developed (including policies with regard to e-commerce and an approval process for the introduction of products, systems and projects) and the principle of internal risk assessment was further implemented. Improvement of systems for measuring operational risk is under development and will help to translate operational risk into necessary economic capital to fulfil capital requirements.

2. The corporate centre

a) The role and influence of the corporate centre

The corporate centre is in charge of the governance of AA and supports and stimulates the SBUs in the execution of their business strategies. Corporate centre goals are: 1) to sustain and strengthen the primary goal of maximalisation of shareholder value throughout the group, 2) to see to it that the business units implement strategies consistently and achieve results necessary to generate a superior yield for shareholders, and 3) to administer the portfolio of AA-units in order to promote synergy benefits. The GMB will focus on the development of group strategy, resource allocation to the different SBUs, performance management, determination of potential synergies between the SBUs on material investments and acquisitions. A full delegation of operational responsibilities to the SBUs is a fundamental aspect of the restructuring. The GMB does keep the final responsibility for strategy development on SBU level (ABN AMRO, 2001, p.19ff). Certain necessary policies, decision-making and setting standards also remain at the group level. Part of the governance role of the corporate centre is strategic decision support. Transparent performance contracts between the GMB and the SBUs are a result of that and pave the way for MfV (ABN AMRO, 2001, p.26). These four-year performance contracts, which substitute annual budgets and which links strategy, resources and performance, are signed between the CFO and the head of each SBU; the corporate centre commits to the resources and the SBU commits to the performance. The corporate centre has adopted a leadership model in which it works in collaborating partnership with the SBUs; in principle SBUs are autonomous. This becomes clear from the fact that the role of the corporate centre in strategy formulation has been much smaller in 2000 than in previous years (Van Dun, 2000, p.22). The soundness of business plans and budgets are evaluated by the corporate centre that will allocate resources accordingly. Thus, the corporate centre is not involved in the planning and budgeting processes of the SBU's but does evaluate the resulting plans and budgets. Monthly discussions between the GMB and the business units about the divisional performance is classified as 'friendly' but does not involve a fundamental discussion about the goals and objectives to be achieved. The relationship between corporate planning and control and divisional planning and control is functional and characterised as 'loose'. The allocation of corporate centre costs is often a point of disagreement between the corporate centre and the business units. For coordination purposes, AA has the committees as shown in Table 52.

Cross-SBU Committee	**Chair**	**Other members**	**Activity**
Group Asset & Liability Committee	CFO	GMB members who are chairman of an SBU, SEVP Market Risk Management, SEVP Group Finance, SEVP Global Financial Markets, CFOs SBUs, EVP ALM, Chief Economist	Responsibilities are corporate wide risk measurement methodology, overall risk limit setting per SBU and per currency for interest rate and liquidity mismatches, management of the consolidated liquidity and interest rate position of the bank, monitoring, analysing and advising the GMB on usage of capital per SBU, management of corporate capital structure, standard and policy setting for transfer pricing and inter SBU transactions, corporate investment portfolio management, and hedging the invested capital and profits in foreign exchange
Controllers meeting	CFO	SEVP and EVPs Group Finance, CFOs and controllers of the three SBUs	Involves policy and operational issues with regard to the finance function, including management information systems and capital allocation topics

Cross-SBU Committee	**Chair**	**Other members**	**Activity**
IS Board	CFO	COOs of the three SBUs, a business/IT representative for each SBU, EVP Group Organisation & Information Management, EVP Group ICT, EVP Group Audit	Advises the GMB on strategic ICT matters. The objective of this committee is to secure IT strategy, standardization and shared IT development as corporate agenda points and to stimulate synergy in the area of IT
Corporate Remuneration Committee	CFO	GMB-members who are chairman of an SBU, SEV Group HR, EVP Corporate Career	Focuses on compensation and benefit issues of senior management
Group Operational Risk Committee	CFO	CFO and COO of each SBU, representatives of Risk Management, Group Finance, Group Audit, Corporate Compliance & Security, Group Organisation & Information Management, OR Policy & Support	Defines and approves policies and standards on operational risk management
(Policy) Group Risk Committee	On rotation basis Head Risk Mgmnt and two senior members of the dept Risk Mgmnt	One GMB member for each SBU, representatives of Risk Management of the SBUs, Credit Risk Management, Portfolio Management, Loan Products and other businesses	This was previously called the ‘Concern Krediet College’. The meeting takes place three times a week, with the Friday meeting focussed on policy issues
Human Resources Board	Head Corporate Centre	Head Group HR, Group HR members, heads HR SBUs	Deals with group wide human resource topics

Cross-SBU Committee	Chair	Other members	Activity
Resource Allocation and Performance Management Committee	CFO	Representatives of the SBUs and the Chairman of the GMB, SEVP and EVP group Finance	Advises the GMB, the SBUs and the corporate centre on optimizing economic value creation in the setting of targets, the allocation of resources and the fixing of budgets. It assesses the business plans and reviews performance of the (S)BUs

Table 52: Cross-SBU committees of AA

b) Corporate centre functions and structure

In including functions in the corporate centre, the guiding principle is that corporate wide supporting activities will take place in the corporate centre and business unit specific supporting activities will take place in the business units (Van Dun, 2000, p.27)[1]. Table 53 shows the functions in the corporate centre (ABN AMRO, 2001, p.27ff). The reporting lines in the corporate centre are shown in Figure 48.

Reporting line	Function	Main activity	Role
Chairman	Corporate Communications (including Investor Relations)	Responsible for the in- and external communication of AA; also responsible for the preservation an improvement of the bank's reputation	Core
Chairman	Corporate Development	Functions as consultant to the GMB in the management of the total portfolio; responsible for signalling and analysis of group level merger- and acquisition possibilities and the preservation of appropriate criteria	Added value

[1] Update: In the first half of 2001, AA made an assessment of its corporate centre. The goals were to increase the transparency of the corporate centre and to decrease the number of corporate centre staff from 650 fte to 520 fte. AA distinguishes between three types of functions: 1) Governance: tasks supporting the executive board in their (strategic) decision-making, 2) Standard and policy setting: the setting of standards and policies to be implemented by the SBUs, and 3) Shared Services: tasks benefiting the SBUs, but which are bundled in the corporate centre because of economies of scale or scope; starting point is that the corporate centre does not take care of shared services unless explicitly requested by the SBUs or when they are strongly associated with the other two tasks. The first two functions were analysed with a focus on their efficiency and the latter task was assessed on the possibility for decentralisation.

Reporting line	Function	Main activity	Role
Chairman	Group Audit	Independent investigation of the quality of risk management within the group including the central supervision of basics and values of auditing (the operational audit responsibility devolved to the SBUs)	Core
CFO	Group Finance	Responsible for budgeting for 2001 to financial and strategic planning over several years including resource allocation and performance management, development of a blueprint for a new group wide management information system, consolidation and external reporting, setting standards for administrative organisation, MfV implementation and maintenance, joint responsibility with the SBUs for realization of synergies and the production of models for Service Level Agreements and mechanisms for transfer pricing.	Core
CFO	Group Risk Management	Formulation of policies on risk policy and risk assessment, authorization of transactions above a certain SBU limit, credit portfolio management, approval of new financial instruments and quantitative models, the validation of risks and the management/ administration of cross-border risks and risks on governments	Core
CFO	Group Information and Communication Technology	Develops, approves and checks for compliance ICT standards and policies, leveraging group wide ICT buying power (together with SBUs)	Shared services

Reporting line	**Function**	**Main activity**	**Role**
CFO	Group Human Resources	Supports the SBUs by offering best practices for recruitment and retaining of personnel, advising the GMB on people aspects and requirements for business strategy; also responsible for team work, sharing of knowledge and career moves over the SBU boundaries is stimulated	Core
CFO	Corporate Affairs	Contains compliance, legal affairs, fiscal affairs and economic research	Core and shared services
CFO	EU-Liaison Office	EU-level government affairs	Core
CFO	Group Asset & Liability Management	Reporting to Group Risk Management and Group Finance, it is responsible for the balance sheet structure and liquidity management; advising the GMB on capital usage per SBU, responsible for consolidated interest positions, hedging of income and invested capital, the portfolio of participations and financing strategies	Core

Table 53: Corporate centre functions and responsibilities at AA

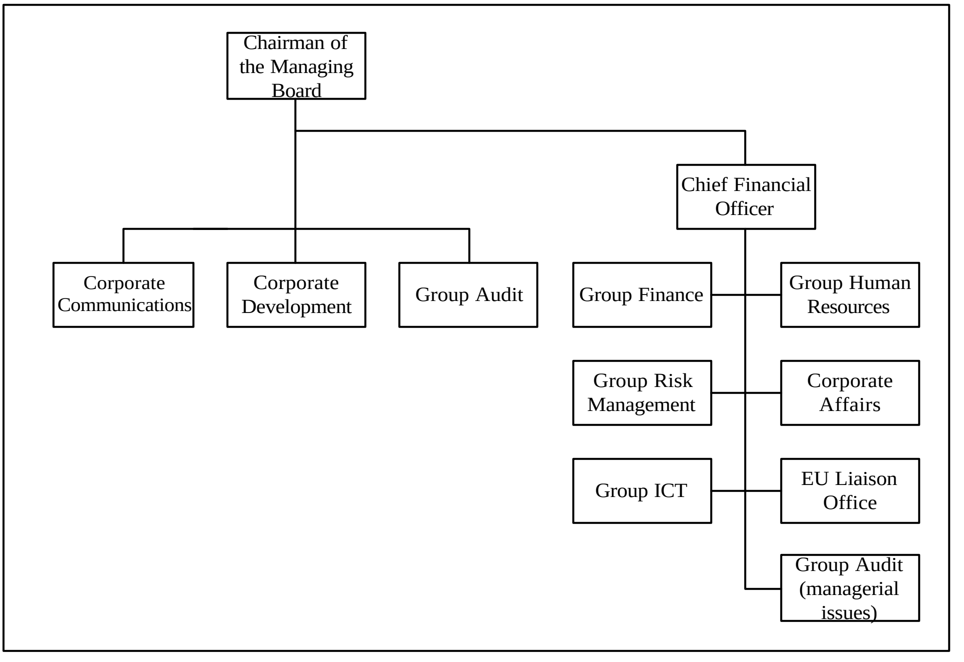


Figure 48: Organisation chart of the corporate centre of AA

c) Corporate centre economics

The corporate centre activities are bound by performance contracts. As corporate centre' financial performance is difficult to define, key performance indicators are still in the process of being defined. Corporate centre department managers and the head of the corporate centre sign the performance contracts, based on business plans and budgets. Finally, the collection of these contracts are bundled into one and agreed upon between the head corporate centre and the Chairman. The corporate centre departments are seen as cost centres. The added value activities in the corporate centre departments are benchmarked. Due to the unique character of the corporate centre functions, outsourcing is not seen as viable. Non-financial performance measurement does not take place. The total cost of the corporate centre is charged to the SBUs.

3. Conclusion

The corporate centre of AA is in the process of being formed, of which table 54 shows the comparison with the ICCC.

Characteristic	**Actual situation in 2000**
Conglomeration	"German/British" variant shifting to the weak form of conglomeration
Nature of corporate centre	
Role and functions	Primarily core and added value, functions almost match ICCC in full; outsourcing not seen as option
Coordination instruments per function	Focused role standardisation, plans, goals, budgets
Contribution, value-based management and operational risk	Potential for contribution present, implementation unclear; value and operational risk orientation present, implementation in unclear
Management and organisation of the corporate centre	
Solving managerial issues	Performance contracts and committees are in place; transparency improves to keep influence costs low; solution for moral hazard unclear
Corporate centre management style	Coming from strategic control to financial control, equilibrium not reached yet, but targeted at ideal position
Staffing the corporate centre	Staffing level (650 fte, 0.6% of group) below lower limit of 1,493 fte 1.3% of group (upper limit is 2,394 fte, 2.1% of group)
Corporate centre economics	
Financial orientation	All departments are cost centres, corporate centre controlling unclear
Approximation of value and costs	Value measurement not performed, cost management unclear, non-financial performance measurements not present, benchmarking unclear
Corporate centre cost allocation	100% Cost allocation performed via performance contracts, practice of allocation procedure unclear

Table 54: Conclusion on the corporate centre of AA in 2000

It seems that in 2000, the corporate centre of AA was not exposed to demands of variety, such as questions of outsourcing or market replication. Corporate centre design is principally according to the ICCC. However, it is unclear if instruments are used effectively. As staffing is low, the full potential of the corporate centre may not be reached. Also, implementation of various programs is unclear.

II. Credit Suisse Group

1. General observations

a) Introduction

Credit Suisse Group AG (CSG)[1] is a global financial services company, including banking and insurance, of 80,538 people (of which 35.1 percent in Switzerland) active in 30 countries and headquartered in Zurich, Switzerland[2]. Its balance sheet totals CHF 987 bn (€ 652 bn)[3], net profits were CHF 5.8 bn (€ 3.8 bn) and the market capitalization was CHF 92.5 bn (€ 61,1 bn) (Credit Suisse Group, 2001). CSG, presided by the Group Executive Board (GxB), is organised in a corporate centre and four business units (see also Figure 49):

1. Corporate Center[4], with 162 fte, based in Zurich, Switzerland
2. Credit Suisse Asset Management, with 2,350 fte, based in London, United Kingdom
3. Credit Suisse Financial Services, including Winterthur Insurance and retail banking, with 40,577 fte, based in Zurich, Switzerland
4. Credit Suisse First Boston, investment banking, with 28,122 fte, based in New York City, NY, United States
5. Credit Suisse Private Banking, with 8,665 fte, based in Zurich, Switzerland.

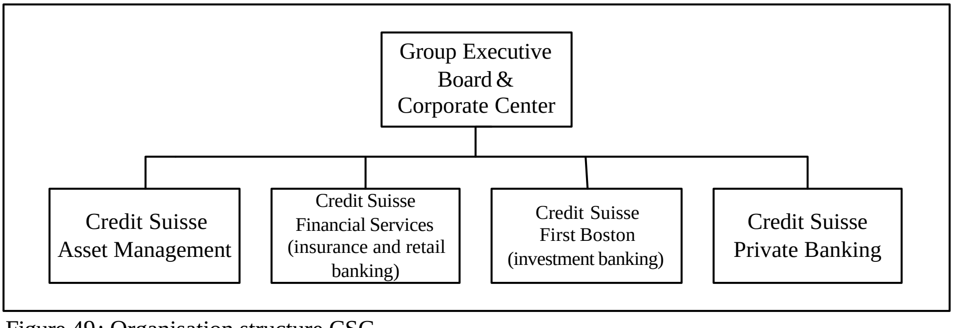


Figure 49: Organisation structure CSG

CSG has been reorganised in 1996 and 1997 (Jung, 2000, p.105ff) and since then has consequently moved further towards the weak form of conglomeration.

[1] The corporate centre of Credit Suisse Group was studied during 2000. Dynamic as the financial services industry is, many changes took place during and after 2000
[2] For a description of the history of Credit Suisse Group, we refer to Jung (2000).
[3] At an exchange rate of €/CHF of 1.5136 on 31.12.2000 (source: Bloomberg).
[4] The corporate centre also includes units not allocated to the business units (662 fte); the first Corporate Centre was already established in 1989 (Jung, 2000, p.334) and has evolved from a financial holding into a management holding since then.

b) Value orientation

During 2000, CSG introduced Value-based Analysis (VBA), which subtracts the cost of capital used in the business from cash flow to measure value created in a given period. CSG will use VBA in both performance measurements of its business units and in management compensation (Credit Suisse Group, 2001, p.5). Main priorities for the short-term future (Credit Suisse Group, 2001, p.12)[1]: 1) strengthen earnings power by increasing productivity in business areas, and minimise earnings volatility through *strict risk management* and by *optimizing the business mix*, 2) further develop the *potential within the group* by strengthening the brand, and *increase leverage across the group* in distribution, products, expertise and technology, and 3) focus on performance measurement, using *VBA*, and on capital allocation, introducing economic risk capital.

c) Operational risk management

In CSG, operational risk is the risk of adverse impact to the business as a consequence of conducting it in an improper or inadequate manner and may result from external factors. Five major operational risk categories have been distinguished for systematic approach reasons: organisation, policy/process, technology, human, external. Good operational management equates to good management and oversight. It often runs parallel to quality and/or knowledge management, all of which contribute to client satisfaction, a strong brand and shareholder value. The primary aim lies in early identification, prevention and mitigation of operational risks, as well as in timely and meaningful management reporting. Regular group-wide meetings take place to achieve this understanding of priorities and to foster dialogue between the corporate centre and the business units. Knowledge and experience is shared throughout the group to ensure a coordinated approach. Business lines take responsibility for their own operational risks. Operational risk management is not so much an issue of regulatory capital requirements but good management (Credit Suisse Group, 2001, p.43ff, Doerig, 2000).

2. The corporate centre

a) Mission of the corporate centre and business unit' autonomy

The mission of the corporate centre is the setting of group's objectives and assisting implementation by facilitating processes including coordination among business units. Specific areas of corporate centre attention are accounting and controlling, risk and return relationships, shareholder matters, and corporate culture. The corporate centre

[1] Italics added by the author; the author selected these three out of five; the other two focused on the growth of the business of asset gathering and investment banking.

acts as a centre of competence for the business units, specifically for matters concerning tax, acquisitions, human resources, information technology, and legal, and thus creates value. The corporate centre departments are responsible for implementing sub-components of this mission. Also, another value creating activity of the corporate centre is the identification and facilitation of cross-business unit synergies and organisational leverage. Part of this is the avoidance of duplication. The business units are independent and linked via the group executive board and service level and revenue splitting agreements. In resource allocation, the corporate centre has a focus on strategic planning, in which the corporate centre sets the timing and the format for the strategic plans and where the GxB and the board of directors assess these plans. The GxB sets the targets for the business units after discussions with the business units. Further, the business units have full autonomy, except in issues of investor relations and communications, accounting standards and the coordination of strategies. Fine-tuning of interfaces between business units is a matter of the business units themselves (Credit Suisse Group, 2000, p.25). This does result in a culture issue, as it proves difficult to promote one company culture. For coordination purposes, CSG has committees as shown in Table 55 (Credit Suisse Group, 2000, p.9).

Cross-business unit committees	**Chair**	**Other members**	**Activity**
Group IT and Operations Steering Committee	GCFO	A minimum of five members, a representative of the GxB and the respective responsible officers for IT and Operations in the business units as appointed by the GxB	Coordination and monitoring of activities and projects, the establishment of standards and guidelines, the management of interfaces between the business units in the IT and Operations areas as well as the facilitation of IT and Operations activities across the business units; delegation of group tasks to the business units where appropriate; ensuring that IT and Operations strategies, planning and budgeting processes, architectures and standards etc. are established within each business unit (the committee does not define the contents of such instruments, apart from group interests and business unit interfaces); supported by a CIO-office (in the corporate centre – EF)

Cross-business unit committees	**Chair**	**Other members**	**Activity**
Group Risk Coordination Committee	GCRO	A minimum of five GxB-members and risk management officers on group level as well as in the BU´s as appointed by GxB	Approval of general instructions and standards concerning risk management as well as certain ceilings for the group

Table 55: Cross-BU committees of CSG

b) Corporate centre functions and structure

The corporate centre has the support functions for the GxB and the operational units. The decision on which function is to be included in the corporate centre is done on a case-by-case basis. Also, the corporate centre functions are understood to be too complex to be regarded for outsourcing and therefore cannot be outsourced. Table 56 shows the functions in the corporate centre. The reporting lines in the corporate centre are shown in Figure 50.

Reporting line	**Function**	**Main activity**	**Role**	**Fte**
GCEO	Group Communications	Management of external communications: media relations; financial information and internal information; corporate identity	Core	8.3
GCEO	Public Affairs	Management of bank-related political issues; employee communications; networking with political and economical representatives; management of donations and memberships	Core/ added value	4.6
GCRO	Special Advisory	Management support in case of acquisitions; risk policy; special advisory Middle East	Added value	n/a

Reporting line	Function	Main activity	Role	Fte
GCRO	Executive Relations	Client contacts at Board level; representations	Core	1.9
GCRO	Risk Management	Group level consolidation of risk reporting; concentration analysis; risk adjusted capital allocation/performance measurement; OR-management	Core	17
GCRO	Management Support	N/A	Shared services	N/A
GCFO	Group Accounting & Reporting	Ensure delivery of legal and business unit financials and key performance indicators, drive allocation process, cash management and management of FX positions, maintenance of communication on relevant subjects	Core	28.5
GCFO	Legal Services	Optimisation of group structure, e.g. acquisitions, divestitures; legal and regulatory advice to group management and business units; coordination of inter business unit legal and compliance issues; relations to Swiss regulators and professional associations	Core	6.7
GCFO	Tax	Swiss tax coordination, tax compliance activities; front support in tax matters; contribute to tax policies	Core	12.5
GCFO	Investor Relations	Maintain relations with the investment community and rating agencies; annual report and shareholder letters; regular review meetings	Core	3.0

Reporting line	Function	Main activity	Role	Fte
GCFO	Group IT Office	Aligning IT activities and Group business objectives; enabling senior management to see the common threads and interactions among separate business units	Shared services	14.5
GCFO	Corporate Development & Finance	Corporate business development, i.e. support of strategic plan; strategic mid-term planning influencing capital allocation process; capital management; group insurance	Added value	5.2
GCFO	Funding	Capital and funding optimisation	Core	0.9
CoS	Human Resources	Operative human resource management of corporate centre; strategic human resource management of the Group; coordination of human resource management of the business units; pension fund and insurances	Core	15.6
CoS	Foundations/Corporate History	Management of foundations; corporate history	Shared services	44.0
CoS	Logistic Support	Procurement of materials; organisation of infrastructure, cost management and controlling e.g. on running cost (only for the corporate centre)	Shared services	6.0
Chairman	Corporate secretary	Provide management assistance to the Chairman, management of the share register	Shared services	8.1
Chairman	Audit	N/A	Core	N/A

Reporting line	Function	Main activity	Role	Fte
Chairman	Security & Investigations	Provide security training (also for intelligence), -engineering and -audits, and event security and advisory services on security; detection and investigation of criminal cases; recovery activities of financial and human resources; administration of cases and trends	Shared services	11.0

Table 56: Corporate centre functions and responsibilities at CSG

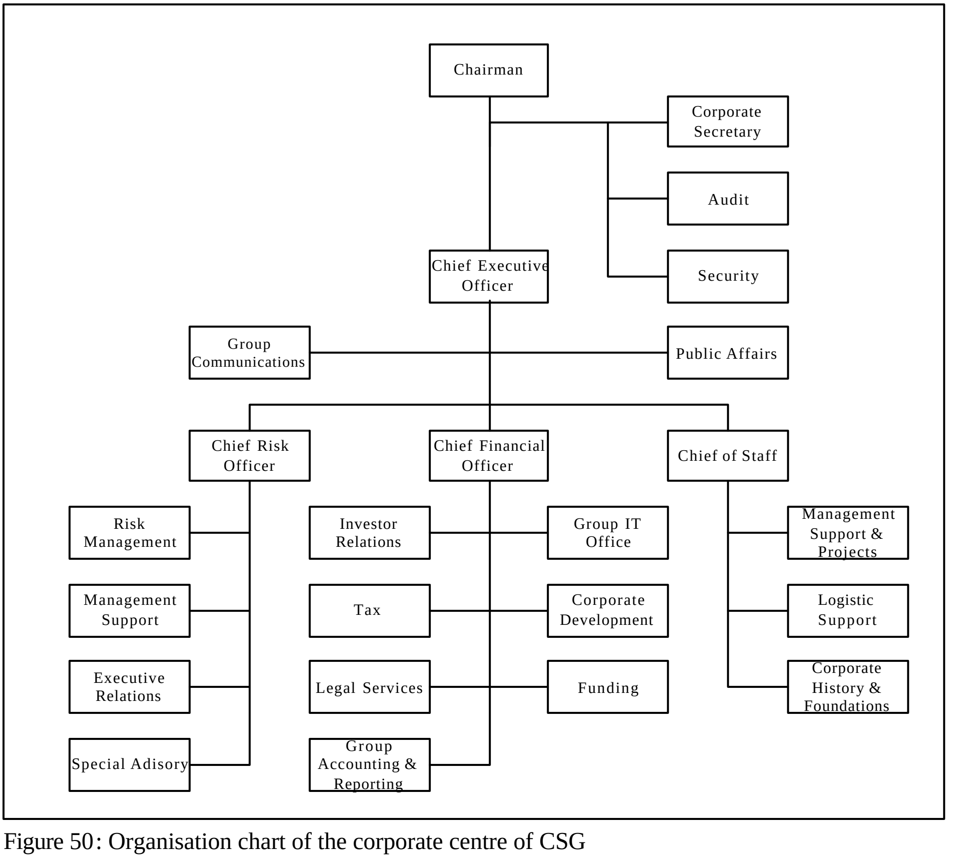


Figure 50: Organisation chart of the corporate centre of CSG

c) Corporate centre economics

Measuring the creation of shareholder value is done internally and results in a value of zero to negative. For the year 2000, the reported value creation for the corporate centre is - CHF 564 mio; corporate centre costs, including adjustments, yielded a net profit of - CHF 162 mio[1]. The corporate centre is seen as a cost block and therefore cost management is seen as most important. On a monthly basis actual vs. budget comparisons are produced by the controlling function, as information for corporate centre department heads. Corporate centre performance and cost control is done by presenting monthly reports to the GCEO and the GCFO. *Group Accounting & Reporting*, the GCFO and the corporate centre department heads together supervise corporate centre costs. Corporate centre controlling plainly *reports* on costs. The corporate centre department heads are the owners of the costs, although allocated costs are less felt to be owned. Issues are resolved through management by exception. As the corporate centre is not seen as a business unit by itself, there is no business planning process. Also the corporate centre does not have a tool for qualitative performance measurement and there is no detailed recording of activities (time sheets). Corporate centre departments have defined success factors, which are reviewed by corporate centre department heads on a periodic basis and annually with supervisors. Corporate centre action items are discussed on a bilateral basis between a corporate centre department head and his or her superior. Corporate centre controlling performs the corporate centre budget process, which will change to a rolling forecast. Budget approval by the GCEO and GCFO is the ultimate hurdle for corporate centre managers. Corporate centre cost allocations[2] take place via service level agreements and have the aim of reflecting the pricing structure of an unrelated third party transaction, although this is not achieved in all cases (Credit Suisse Group, 2001, p.14). Service level agreements are negotiated periodically by the relevant business units with regard to each individual product or service. This allocation results in the percentages as in Table 57[3].

Credit Suisse Asset Management	Credit Suisse Financial Services[4]	Credit Suisse First Boston	Credit Suisse Private Banking
8%	33%	21%	16%

Table 57: CSG corporate centre operating costs allocated in 2000

[1] Excluding a charge for restructuring provision of almost CHF 1.1 bn (Credit Suisse Group, 2001, p.8).

[2] General characteristics of allocation in CSG, not specific for the corporate centre, are reported to be (Voegelin, 1999, p.280ff): costs allocated to "causing" business units, exploitation of synergies by concentration of resources and market power in one place in the group, maximum transfer of direct and allocated costs to the business units, move from cost-sharing concept towards a more market oriented service practice, encourage service providers to be more competitive with external market, and improve efficiency within individual business units.

[3] 22% remains in the corporate centre

[4] Winterthur 12 % and Credit Suisse Banking 21%.

3. Conclusion

The corporate centre of CSG has been formed following a course of high level of decentralisation. Table 58 shows the conclusion of the comparison of the corporate centre of CSG with the ICCC.

Characteristic	**Actual situation in 2000**
Conglomeration	Weak form
Nature of corporate centre	
Role and functions	Core, added value, and shared services; functions match ICCC in part
Coordination instruments per function	Focused and effective culture, role standardisation, plans, goals, budgets
Contribution, value-based management and operational risk	Potential for contribution present, implementation missing; value and operational risk orientation present, implementation unclear
Management and organisation of the corporate centre	
Solving managerial issues	Performance contracts present; very few committees, transparency keep influence costs low, solution for moral hazard unclear
Corporate centre management style	Financial control
Staffing the corporate centre	Staffing level (162 fte, 0.2% of group) much below lower limit of 1,045 fte, 1.3% of group (upper limit is 1,675 fte, 2.1% of group)
Corporate centre economics	
Financial orientation	All departments are cost centres, corporate centre controlling active
Approximation of value and costs	Value measurement performed, cost management performed, non-financial performance measurements not present, benchmarking unclear
Corporate centre cost allocation	78% Cost allocation, performed via service level agreements, process and effectiveness unclear

Table 58: Conclusion on the corporate centre of CSG in 2000

In 2000, the corporate centre was rather small in terms of staffing; it seems that exploring and realising synergies is left to the business units. The formal structure matches the ICCC to some respect. Implementation of value orientation is partially done. Having a smaller corporate centre may make the implementation of formal programs less necessary; management might be able to monitor implementation easier without formal programs. However, the synergy potential is possibly not reached.

III. Deutsche Bank

1. General observations

a) Introduction

Deutsche Bank AG (DB)[1] is a *multi-specialty* bank of 98,311 people (of which 51.5 percent in Germany) working in 73 countries and headquartered in Frankfurt, Germany, where also all divisions have their base. Its balance sheet totals € 940 bn, net profits were € 4.9 bn and its market capitalization was € 55.2 bn (Deutsche Bank, 2001). DB, presided by the Group Board of Managing Directors (BMD), is organised in five divisions, a corporate centre and a support centre, which are all based in Frankfurt (see also Figure 51):

1. Asset Management, with 4,916 fte[2]
2. Corporates & Real Estate, with 13,764 fte
3. Global Corporates & Institutions, with 17,696 fte
4. Global Technology & Services, with 24,578 fte
5. Retail & Private Banking, with 32,443 fte
6. Corporate Centre, with 879 fte
7. Support Centre, with 4,037 fte.

During 2001, Deutsche Bank reorganised into the business groups Corporate and Investment Bank and Private Clients and Asset Management, and the units DB Services and Corporate Investments. Over the years, DB has been and still is moving from the German variant towards the American variant of universal banking.

[1] The corporate centre of Deutsche Bank was studied during 2000. Dynamic as the financial services industry is, many changes took place during and after 2000.
[2] Full time equivalents, ultimo 2000.

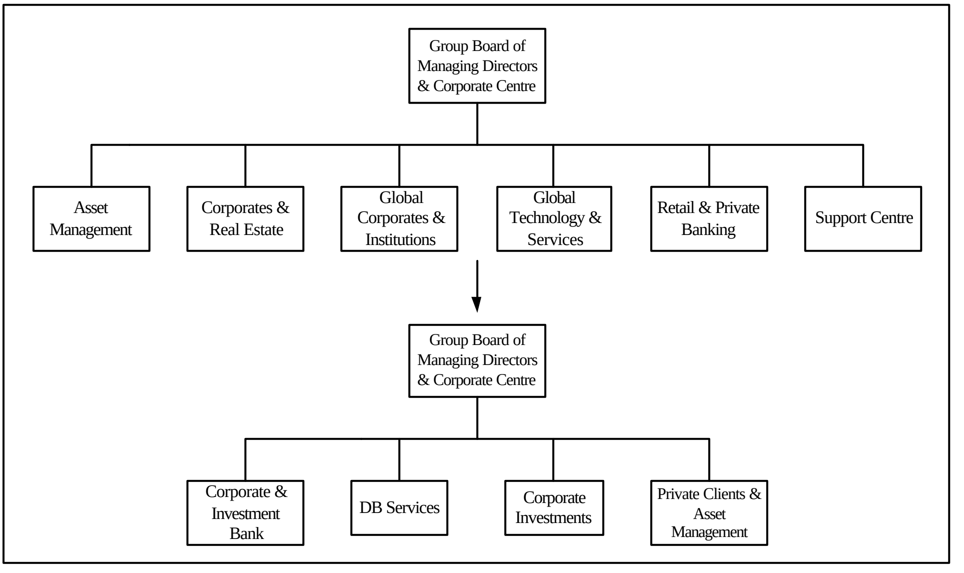


Figure 51: Changing organisational structure DB

b) Value orientation

DB regards shareholders, customers, staff and society as its four key stakeholders with equal status. Maintaining a balance forms a compelling task. DB's corporate identity is to create lasting added value for these stakeholders (Deutsche Bank, 2001, p.12).

c) Operational risk management

DB's risk philosophy is underpinned by its objective to maximise shareholder returns within the framework of the overall risk appetite. DB defines operational risk as the potential for incurring losses through unmanageable events, business disruption, inadequately defined controls or control/system failure in relation to staff, customer relationships, technology, assets, other third parties/regulators as well as project and other risks (Deutsche Bank, 2001, p.140). DB expects operational risk to be a major challenge to the financial services sector in the coming years and has begun to implement a framework for operational risks on a global basis. An operational risk guideline, implemented last year, defines roles and responsibilities concerning the management and reporting of operational risks in the group (Deutsche Bank, 2001, p.165ff). Responsibility for operational risk management essentially lies with the group divisions. They bear the risk and they decide in what form and on what scale they accept, control or reduce risk. They also decide what form of risk prevention measures have to be applied. In this context, an important role is played by a cost/benefit analysis. Responsibility for operational risks, parallel to the existing functions for credit and market risks, has been integrated into the bank's risk management, which is independent of the business divisions. The GCRO has appointed a Chief Risk Officer for operational risks group wide (CRO OR). The CRO OR is represented on the Group Risk Board and is Chairman of the Operational Risk Committee. This committee, whose members include the divisional Operational Risk Officers and representatives of important staff functions, develops and implements the Group's internal guidelines for managing operational risk. An important element of the framework is the self-assessment for operational risk developed by the bank (db Risk Map). This self-assessment creates an overview of the current risk profile within the business divisions and helps to define risk management measures, priorities and risk indicators. These will be monitored, besides other risk indicators for operational risk identified as relevant by the industry, in the bank's scorecard system which is currently being rolled out. A group wide database for the reporting of losses from operational risk events (db IRS) provides information about the success of risk management as well as feedback on the quality of the risk indicators selected. The use of these instruments will enable complete and consistent operational risk reporting at divisional and group level.

2. The corporate centre

a) The role and operational mode of the corporate centre

The corporate centre was formed as a result of the decision in the recent past that the bank should be organised along business lines instead of regions. The corporate centre, as seen by DB as a virtual holding and as a cross-divisional function, supports the BMD in directing the group divisions and subsidiaries towards global group targets. The corporate centre ensures, through policies, common standards and co-ordinated decision proposals, that BMD policy is pursued in a consistent and target-oriented manner. Also, the corporate centre is responsible for group-wide supra-divisional planning, steering and control, as well as for monitoring of and compliance with external requirements; it ensures optimal allocation of financial resources between the divisions and makes an important contribution to the exchange of information between operating units. In doing so, the corporate centre aims to contribute to long-term growth in the value of DB. As the tasks of the corporate centre are primarily of a strategic nature, the corporate centre units focus on the strategic management of the key resources, human and financial capital, as well as on group corporate branding. In particular, DB considers efficient risk management to be an indispensable core capability in banking business and the corporate centre houses risk-relevant functions, which report neutrally on risks in the group. These functions, together with in- and external communications, which are also part of the corporate centre, make up a strong unit ensuring strategic consistency within the group (Deutsche Bank, 2001, p.42). The divisions are seen as having far reaching autonomy in some cases and no autonomy in others, especially in risk-relevant areas. The corporate centre works closely with divisions on projects in areas such as Controlling, Treasury, and Risk Management. The corporate centre works for all members of the BMD, but is managed by the members of the BMD, which do not head an operational division. The BMD has delegated the following rights of functional direction and disciplinary participation to the corporate centre:

- The corporate centre units have the power to issue guidelines for all functional matters concerning them, the right to control compliance with standards and the right to institute sanctions in the group; functional responsibility lies with the respective BMD-members
- Senior executive positions in divisional functions are filled subject to agreement between the corporate centre units and divisions; the corporate centre units have proposal right
- Remuneration questions, bonus arrangements, target agreements, appraisals, promotions and specific personnel measures for senior executive positions are agreed by the corporate centre.

DB has several cross-divisional committees; because of the group interest, these are presided by corporate centre delegates; examp les are shown in Table 59.

Cross-divisional Committee	**Chair**	**Other members**	**Activity**
Group Risk Board	GCRO	Divisional CROs, Chief of Staff Risk	Risk strategy, risk regulations, -principles- and methods, credit processes, risk organisation, nomination of SC Es, risk portfolio analyses and management, risk capital planning, risk cost

Cross-divisional Committee	**Chair**	**Other members**	**Activity**
Group Credit Policy Committee	Head Group Credit Risk	Divisional CROs, Chief of Staff Risk	Quarterly evaluation of divisional credit portfolios, approval of credit principles, approval and recommendation of country limits, industry reports and supra-divisional portfolio management transactions
Global Risk Committee	GCRO	Divisional CROs, Chief of Staff Risk, Heads of different CC departments (Treasury, Controlling, Legal, Audit, Research)	Information and discussion on actual risk position of DB Group, collective management action if risk concentrates
Human Resources Board		Divisional Heads Human Resources	Group wide coordination of Human Resource policies
Business Area Controllers Meeting	CFO	Business area controllers	Group wide coordination of controlling issues
Investment Committee	N/A	Head Group Participations, Head Group Controlling, Head Group Treasury	N/A
Asset and Liability Committee	Treasury	Local and divisional management representatives, controlling, treasury	Policies on capital issues, transfer prices, liquidity, refinancing and bank equity.

Table 59: Cross-divisional committees of DB

b) Corporate centre functions and structure

DB has different functions which support multiple divisions but which are not part of the corporate centre. These operational functions are organised in the separate division called Global Technology & Services and are back-office in nature. They encompass purchasing, payments, securities processing, custody services and electronic banking services. There are various centralised areas:

1. Corporate centre (CCC): all functions, which are necessary to counsel and support the BMD in its task to manage DB-group and to report neutrally on risks. Goals: alignment of divisional and corporate goals, resource allocation, safeguarding a uniform and strong group appearance in- and externally
2. Support centre (SC): supra-divisional functions of Controlling (systematic and efficient production of controlling information and standard reports), Audit, Corporate Real Estate and Services, Corporate Security and Human Resources (salary administration, training for German based part of DB and human resource counselling) are bundled to achieve synergies
3. Divisional functions (DF) with 5193 fte: division-specific activities, which previously were performed by the corporate centre; during 2000 they are being allocated to the divisions, which can organise them as they see fit.

CCC-functions have functional and disciplinary rights to issue directives towards divisional functions, functional rights to issue directives and disciplinary rights to assist towards the support centre. In case of important issues the CCC and the DF distribute competencies among themselves. Between the SC on the one and the CCC and the DF on the other hand, settlement of supplied services takes place. Relationships as per Figure 52. The corporate centre functional concept is depicted in Figure 53.

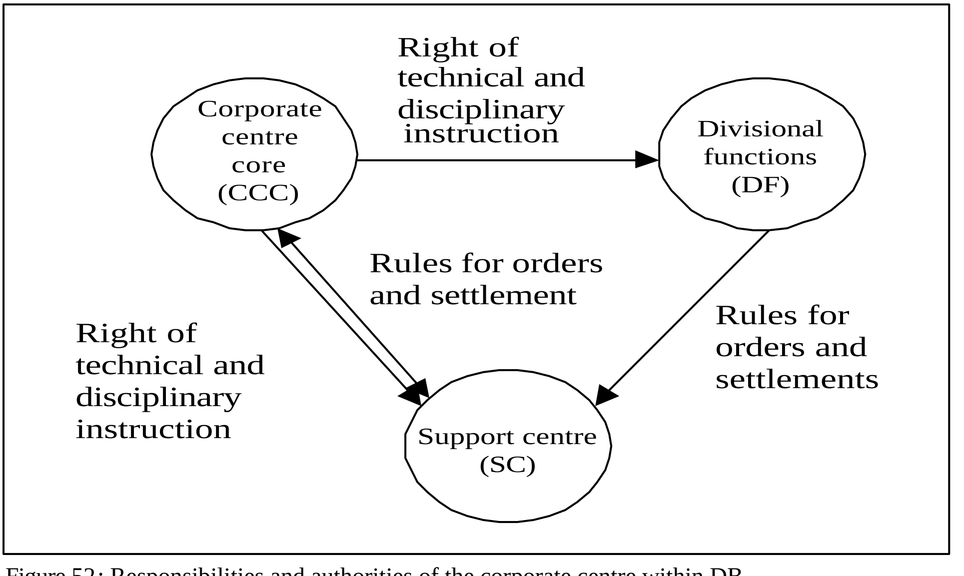


Figure 52: Responsibilities and authorities of the corporate centre within DB

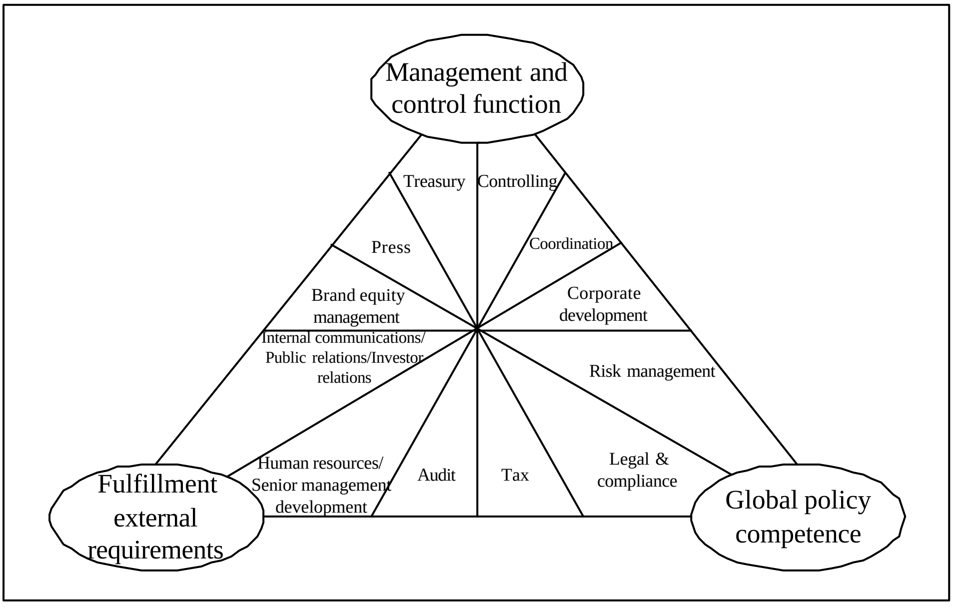


Figure 53: Corporate centre functional concept of DB

The corporate centre houses the functions as shown in Table 60.

Reporting line	**Sector**	**Main activity**	**Role**
CBMD	Group Press	Advising BMD in all media questions, development and execution of communications concepts, safeguarding compliance with uniform standards and ensuring co-ordinated market approach under DB brand name, steering and coordination of media activities	Core

Reporting line	**Sector**	**Main activity**	**Role**
CBMD	Corporate Development	Domestic and international consolidation, pro-active portfolio management, e-commerce, group structure and role of the corporate centre, development, formulation and execution if a consistent, concise group strategy, environmental scanning, benchmarking, gathering of competitor intelligence, war gaming, conducting ongoing strategic dialogue with group divisions and business areas, reconciling group division and business areas strategies with overall group strategy, managing and/or monitoring specific strategic projects, executing mergers, acquisitions, disinvestments, and restructurings, setting-up of joint ventures, co-operations and strategic alliances, managing direct group investments outside divisional responsibilities and DB Investor, administration, reporting and mandates	Added value
CBMD	Group Press	Advising BMD in all media questions, development and execution of communications concepts, safeguarding compliance with uniform standards and ensuring co-ordinated market approach under DB brand name, steering and coordination of media activities	Core

Reporting line	**Sector**	**Main activity**	**Role**
CBMD	Group Marketing & Communications	Brand management, corporate design; brand and market research internally as well as externally; investor relations, positioning planning, public relations, definition of group-wide PR strategy; systematic fostering of relations; sponsoring activities, corporate events and protocol, coordination of mandates and memberships; internal group communications, development, implementation and monitoring of standards, publication of internal supra-divisional media	Added value
CBMD	Group Economic Research	Analysis and forecasting of macro-economic developments and developments on national and global financial markets, including influences of economic policy measures; of fundamental risks, industry and country risks and rating them; development, enforcement and control of standards and guidelines for analyses and forecasts; coordination of economic research	Shared services
CBMD	Group Legal	Policy-oriented and project-related legal advisory for BMD and corporate centre units, ensuring uniform group coverage for group-relevant and supra-divisional legal issues, participation in transactions and businesses with major importance for the group, development and coverage of group-relevant initiatives concerning legislative and regulatory developments to maintain existing fields of business and develop new	Core

Reporting line	Sector	Main activity	Role
CBMD	Group Compliance	Advising BMD and corporate centre units on fundamental supra-divisional, important and extraordinary issues of monitoring compliance with bank and capital market law and conduct and the avoidance of regulatory risks; production of global standards and guidelines as well as systems of direction and reporting for compliance relevant maters, and monitor compliance with them; fostering relations with regulatory authorities	Core
CBMD	Corporate Centre Coordination	N/A	Core
CFO	Group Controlling	Periodically collecting information from divisions on profit, volume and risk, and transposition of the information into analyses and proposals for concrete steering measures	Core
CFO	Group Audit	N/A	Core
CFO	Group Tax	Clarification of fundamental taxation issues, ensure compliance with a corporate tax culture, tax counselling, preparation of tax accounting, external tax audits, coordination of tax departments	Core
CRO	Group Risk Board	Development and setting of group-wide policies and process parameters, limits for single exposures, portfolio segments and country risks; authority to decide or recommend credit proposals; active portfolio management; control of compliance with policies and guidelines	Core

Reporting line	**Sector**	**Main activity**	**Role**
CRO	Group Risk Management	Guidelines for assessment of the Group's market risk exposure; determination of limit structure for market risks; approval of market risk overruns; independent information on limit utilisation and overall risk situation; global process coordination; review and approval of risk and performance models	Core
CRO	Group Treasury	Issuance of debt funding and capital; responsibility for and access to unsecured liquidity in the group; ensuring group solvency; management of interest rate risk associated with all non-trading book assets and liabilities; capital, reserves and capital ratios; processing of capital applications from subsidiaries; coverage of regulators	Added value
CRO	Office of Vice-Chairmen	Risk-policies and training, ex- and internal communication to senior management, risk officials, rating agencies, regulators and equity analysts, and methodology containing risk ratings, pricing tools, research and project management	Core
CHRO	Group Human Resources	Personnel policy guidelines, formulation and implementation of hr-strategies, responsibility for the development of culture values and management, advising on organisational development and change processes, development of hr- tools, implementation of knowledge management and intellectual capital and multi-disciplinary learning systems and	Core

Table 60: Corporate centre functions and responsibilities of DB

The reporting lines of the corporate centre functions are shown in Figure 54.

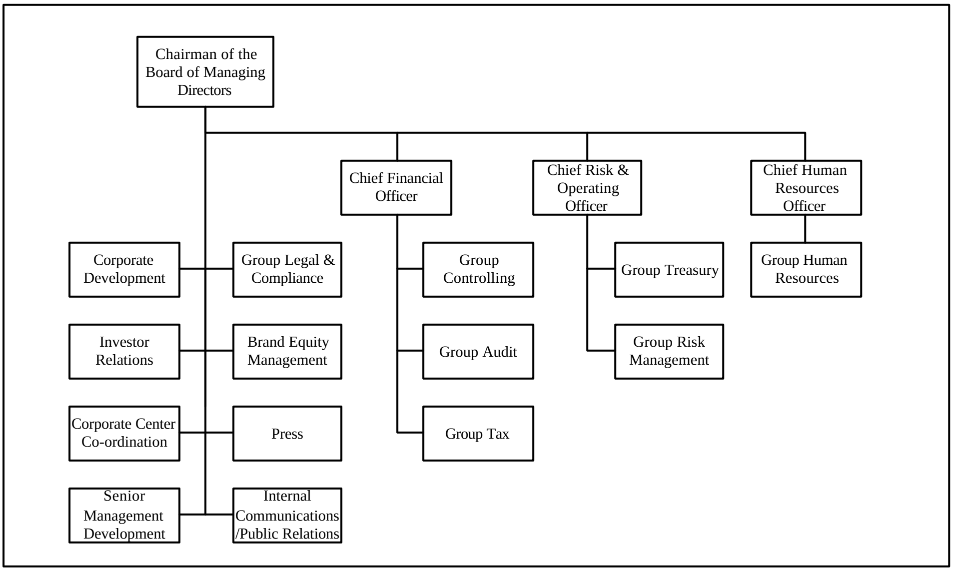


Figure 54: Organisational structure of the corporate centre of DB

c) Corporate centre economics

Corporate centre costs are supervised in the unit *Corporate Center Coordination*. Corporate centre units have employees, who also take care of controlling matters; they report to the corporate centre unit head. The Head Corporate Center Coordination, also responsible for the corporate centre costs, can make recommendations if costs are out of line[1]. In this case the Head Corporate Center Coordination has a moderating role. The Head Corporate Center Coordination meets on a regular basis with the board members responsible for the corporate centre to discuss corporate centre controlling issues, and the numbers receive great scrutiny from corporate centre management. All corporate centre units are managed as cost centres. In trying to keep costs down, the target for CCC is to decrease the number of employees to around 650 fte; this general goal of keeping costs down remains valid in times of growth of total business volume and size of the group. As the corporate centre is a cost generating division, shareholder value creation is not measured. Qualitative measures, occasionally used for projects, take place via a scorecard with the use of so called traffic lights. These lights vary in colour

[1] In 2000, corporate centre profit before tax went up from – € 452 mio to – € 440 mio (Deutsche Bank, 2001).

green, yellow and red and are being set by the corporate centre unit head. The business planning and budgeting process of the corporate centre starts off with targets given to corporate centre management. Then a bottom-up process initiates in which corporate centre management produces business plans and budgets. The budget has validity for 1 year; the business plan stretches over a period of 3 to 5 years. The costs of the SC-functions of the corporate centre are allocated to divisions based on pre-agreed conditions, market oriented prices and on demand of service. Divisions do not procure SC-type services on the external market. Prime motivation is that these services would also be needed when the divisions would be operating independently. It is very difficult to compare DB corporate centre services, benchmarking therefore take place only in cases where comparisons are possible. Notwithstanding that, the relationship between cost of corporate centre service and its quality is subject of intensive discussions. The CCC-costs were planned to be charged to divisions via a fixed key and can be understood as a corporate (centre) levy, a charge for being able to use DB resources such as the brand. A general idea is to analyse corporate centre departments in an ongoing manner as to assess the feasibility of increasing chargeability.

3. Conclusion

The corporate centre of DB is in the process of formation. Table 61 shows the conclusion of the comparison of the corporate centre of DB with the ICCC. In 2000, implementation of a corporate centre concept is done via relative formal ways. This begs the question to what extent the formal and informal organisations are similar. Also, there seems to be a multitude of detailed coordination instruments, which shows the seriousness with which governance is performed but which also might lead to inefficiencies. Mixtures of instruments and management styles might have led to an unfocused appearance. A formal value orientation was not implemented, but using market prices in allocation can lead to market replication. The effectiveness of the corporate centre in reaching synergies might not be maximal due to low staffing level.

Characteristic	Actual situation in 2000
Conglomeration	"German" variant shifting to weak form of conglomeration
Nature of corporate centre	
Role and functions	Core, added value, and shared services; functions match ICCC as far as core and added value are concerned
Coordination instruments per function	Mixed role standardisation, plans, goals, budgets
Contribution, value-based management and operational risk	Potential for contribution present, implementation unclear; value, with focus on multiple stakeholders, and operational risk orientation present, implementation unclear
Management and organisation of the corporate centre	
Solving managerial issues	Service level agreements and committees present; lower transparency leading to higher influence costs, solution for moral hazard unclear
Corporate centre management style	Mixture of Strategic Planning, Strategic Control and Financial Control
Staffing the corporate centre	Staffing level (879 fte, 0.9% of group), below lower limit of 1,275 fte 1.3% of group (lower limit is 2,045 fte, 2.1% of group)
Corporate centre economics	
Financial orientation	All departments arecost centres, corporate centre controlling ok
Approximation of value and costs	Value measurement not performed, cost management performed, non-financial performance measurements not present, benchmarking unclear, project scorecard implemented
Corporate centre cost allocation	100% Cost allocation, based on market prices, performed via service level agreements

Table 61: Conclusion on the corporate centre of DB in 2000

IV. UBS

1. General observations

a) Introduction

UBS AG (UBS)[1] is a global integrated investment services firm and a leading bank in Switzerland of 71,076 people (of which 42 percent in Switzerland) active in over 40 countries and headquartered in Zurich, Switzerland[2]. For 2000, its balance sheet totalled CHF 1,088 bn (€ 719 bn) [3], net profits were CHF 7.8 bn (€ 5.1 bn) and the market capitalization was CHF 112.7 bn (€ 74.4 bn) (UBS AG, 2001a). UBS, presided by the Group Executive Board (GEB), is organised in three business groups and a corporate centre (see also Figure 55):

1. UBS Asset Management, with 2,860 fte, based in Chicago, IL, United States
2. UBS Switzerland, retail, corporate and Swiss private banking with 28,785 fte, based in Zurich, Switzerland
3. UBS Warburg, investment and international private banking, with 38,445 fte, based in London, United Kingdom
4. Corporate Centre[4], with 986 fte, based in Zurich, Switzerland.

UBS is committed to an integrated business model and is not merely a holding company. It is a portfolio of complementary businesses, managed together for optimal shareholder value, where the whole is worth more than the sum of its parts. UBS' business groups are accountable for their results and enjoy considerable autonomy in pursuing their business objectives. However, UBS has to work in a coordinated manner to take advantage of the synergies available from the perspective of strategy and financial performance, both revenue and cost.

[1] The corporate centre of UBS was studied during 2000. Dynamic as the financial services industry is, many changes took place during and after 2000.
[2] The merger of Swiss Bank Corporation and Union Bank of Switzerland forming UBS in 1997/1998 is discussed in Schütz (1998). For a description of the recent history of SBC, one of the two predecessors of UBS, we refer to Rogge (1997).
[3] At an exchange rate of €/CHF of 1.5136 on 31.12.2000 (source: Bloomberg).
[4] The Corporate Centre was formed in 1994, when the group underwent a major reorganisation.

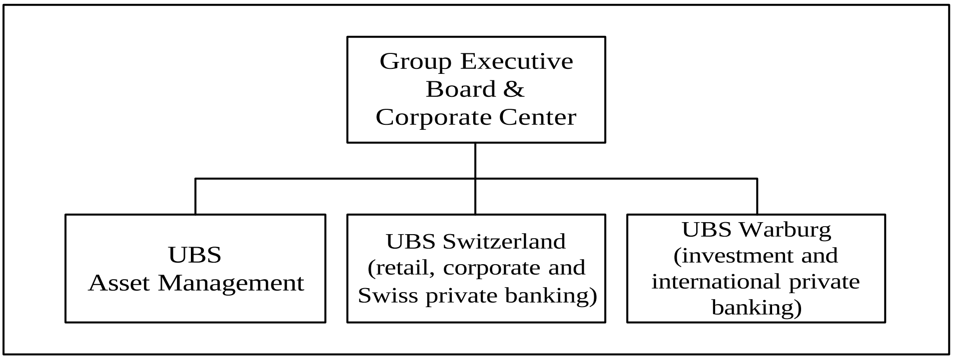


Figure 55: Organisation structure UBS

b) Value orientation

UBS implemented a value-based management (VBM) framework, which supports value-based decisions, performance assessment and external communication. The heart of the framework is a process for monitoring the development of the value of the group and its constituent businesses, based on the identification of the fundamental drivers of value creation (UBS, 2001a, p.38ff). The aim of VBM is to create an understanding of the sources and drivers of value within all of UBS' businesses, and to integrate this understanding into its management processes and principles, translating the value creating mindset into action. Figure 56 summarises the VBM processes. In measuring shareholder value creation, UBS Switzerland uses a value report. Based on the discounted cash flow methodology, the capital asset pricing model and risk adjustments, values for the division are being analysed for sensitivities in the most important value drivers. An important input is the business plan. Part of the value report is the value gap analysis, which is the difference between the internal calculated value and the value calculated by external financial analysts (Haeringer & Stadelmann, 2001, p.1179). The fundamental assumption underlying the VBM framework is that the creation of sustainable value is the primary objective of business activity. By emphasizing sustainable value creation, UBS considers the interests of both its shareholders and other important stakeholders such as employees, clients and regulators. The framework views the management as fiduciaries of shareholder wealth. To ensure long-term success, a company must provide its owners with a total return greater than its risk-adjusted cost of capital. To be truly effective, the VBM framework must become an integrated part of key management processes, such as the formulation and evaluation of strategic plans and investments, the measurement and evaluation of performance, and the definition of criteria for performance related compensation (UBS, 2001a, p.40). In order to have an operational tool for analysing the extent to which current and projected performance contribute to sustainable value creation, UBS has identified for each business unit, relating to revenue, cost and investment.

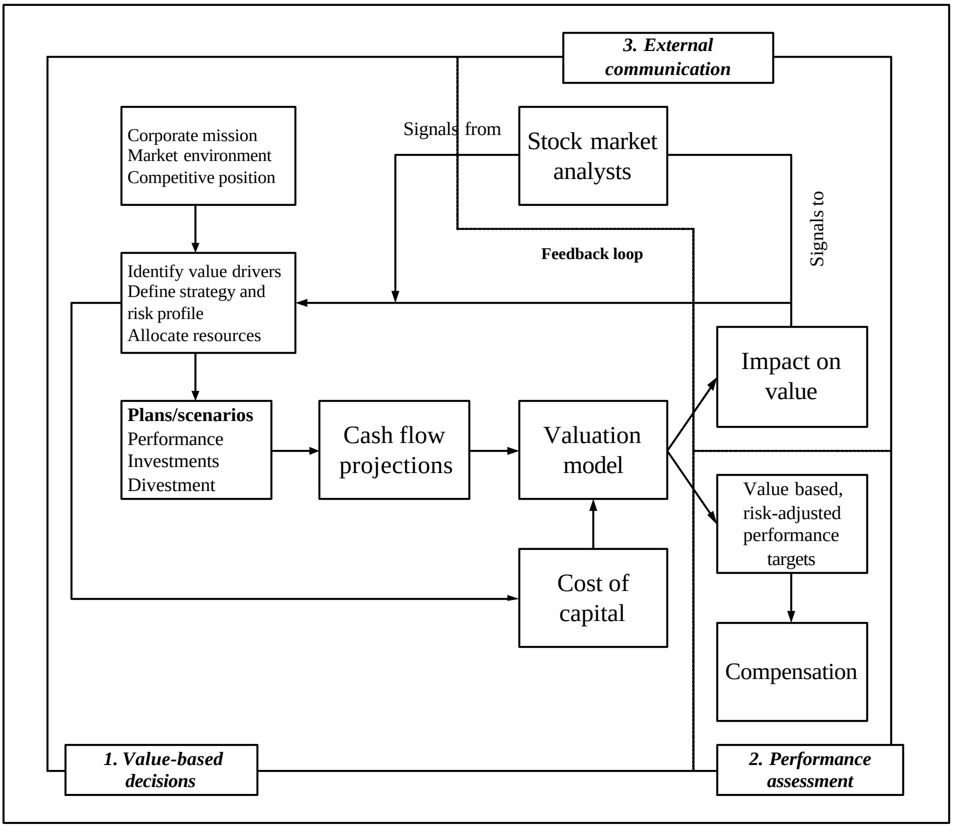


Figure 56: The UBS' VBM framework

c) Operational risk management

UBS calls operational risk consequential risk. The consequential risk categories are transaction processing risk, liability risk, legal risk, compliance risk, security risk and tax risk. UBS is continuing to develop both qualitative and quantitative approaches to the management and control of consequential risks. A measurement framework has been formulated, but full implementation depends on the existence of multi-period exposure and loss data. Current efforts are therefore centred on building this history and on the qualitative aspects of risk management and control – identification and recording of risks and exposures, establishment of policies, standards and procedures, close monitoring and management of identified risks, and initiation of corrective action where necessary in response to incidents (UBS, 2001a, p.66). By identifying and recording these risks and tracking their evolution, UBS will establish the basis from which the quantitative framework can be realised. The consideration of consequential risks is an important element in the assessment of new businesses and of transactions with unusual structure. Under the GCRO and business group CRO's, all consequential risks are now formally integrated into the independent risk control process.

2. The corporate centre

a) Nature of the corporate centre

Due to business and geographical complexity, the role of a focused and professional corporate centre has become invaluable to UBS. The corporate centre objective is to guarantee the professionalism, commercial efficiency and strategic direction of the business groups. In many ways its role is that of an enabler and facilitator for the entire group (UBS, 1999d). UBS perceives the need for a strong corporate centre, with the mission to maximise sustainable shareholder value by coordinating the activities of the business groups. It ensures that they operate as a coherent and effective group with a set of common values and principles. Further, the corporate centre is the only part of the group acknowledged by all the business groups as being neutral and is therefore accepted as independent when interdivisional issues are discussed. The corporate centre contributes to the overall result of the group, in that it has a unifying function and always emphasises group considerations. Thus, it facilitates synergies between the business groups. All sectors aim at enhancing functional and cross-business group co-operation, at avoiding duplications, and subsequently to increase efficiency and profitability. The basic modus operandi for the corporate centre is to have minimal process ownership counterbalanced by strong governance by setting standards and principles (UBS, 2001a, p.37). This way, staffing levels remain low. In practice, this implies that the corporate centre departments are not very influential with the exception of certain themes. In the resource allocation process the corporate centre influence can be classified as weak and process oriented; each step in the process is reached by consensus. Leadership can be classified as minimal with a focus on guidance. Resource allocation has a long-term focus so as to avoid the false appearance of accuracy. Table 62 shows the concrete actions for UBS' corporate centre to fulfil its mission.

	Contribute to the long-term maximization of shareholder value
A	*Ensuring the group is competitively positioned in growing market places with an optimal business model and adequate resources*
1	Define the valuation drivers for the Group and business groups and integrate these into our strategy, performance measurement and external communication
2	Ensure that our financial management policies and actions are co-ordinated with our strategy
3	Develop a communications strategy for the Group and improve the coordination of communications with all constituencies (including regulators)
4	Improve the quality of financial and non financial key performance indicators and competitive benchmarks, and increase the focus on costs and client revenues
5	Identify the opportunities and threats represented by technology and develop strategies to leverage technology to create value
6	Review the IT governance of the Group
7	Design and implement a risk adjusted performance measurement process
8	Optimise the branding strategy for the group
B	*Ensuring the long term financial stability of the group by maintaining an appropriate balance between risk and profit*
1	Improve the Group's overall governance processes and procedures
2	Ensure that the Group has an independent risk organisation
3	Further reinforce the linkages between the control functions (financial, market and credit risk, legal and compliance, etc.)
4	Put in place a credible plan for the improvement in time to market of financial information and the standardisation of financial processes across business groups where appropriate
5	Review the Group's real estate strategy
6	Continue with a pro-active tax planning strategy, with a focus on the issues arising from EU tax coordination
C	*Ensuring that the business groups, while being accountable for their results, operate as a coherent and effective group with a common set of values and principles*
1	Encourage a spirit of teamwork through operating transparently, with integrity, intellectual honesty, flexibility and respect
2	Improve succession planning, introduce mentor schemes for promising talent and improve graduate recruitment
3	Continually reinforce the critical importance of exploiting synergies and implement a commercial approach to Service Level Agreements
4	Implement a rigorous approach to identifying and eliminating duplication
5	Integrate key performance indicators, particularly aimed at cost, into the group's compensation processes

Table 62: UBS’ corporate centre’s actions aimed at shareholder value creation

b) Corporate centre management and organisation

The corporate centre encompasses group level functions, which cannot be devolved to the business groups. Additionally, the corporate centre plays an active role with regard to funding, capital and balance sheet management, and with regard to risk management (UBS, 1999e, p.30). The heads of the functional areas of the corporate centre have functional directive and functional controlling authority throughout the group (UBS, 2000 p.5). The corporate centre houses the functions as shown in Table 63. The reporting lines are depicted in Figure 57.

Reporting line	**Function**	**Main activity**	**Role**	**Fte**
GCFO	Group Controlling	Responsible for devising and implementing integrated and controlling and accounting processes throughout the group, to produce the group's regulatory, financial and management accounts; includes corporate tax, focusing on optimising tax issues; consulting the divisions on tax issues co-ordinating tax aspects with a global perspective, and corporate centre operations: to ensure transparency and accountability of the corporate centre as an operating business group	Core	194
GCEO	Group Communications and Marketing	Effective communication of strategy, values and results to employees, clients, investors and the public, and to support the long term building of a strong global brand by developing and implementing a coherent visual identity and integrated brand and marketing comms	Added value	66

Reporting line	Function	Main activity	Role	Fte
GCEO	Group Human Resources	To create a global employer of choice, able to attract, develop, motivate and retain talents by establishing standards, principles and procedures for performance evaluation, compensation, recruitment, training	Core	34
GCEO	Legal and Compliance	Protects reputation by managing its legal, compliance and regulatory affairs; to counsel on legal and compliance matters; to manage intellectual property	Core	18
GCFO	Group Treasury	Managing group liquidity risk, group funding risk, and non-trading related foreign exchange and interest rate risk; handling financial flows - investment and allocation of regulatory and divisional capital as well as the management of the group's equity. Internal consultancy	Added value	26
Chairman	Group Internal Audit	To assist management and in particular the BoD, in the discharge of their responsibilities to monitor and continually ensure the adequacy of the overall effectiveness of UBS' internal control processes; to provide objective and independent appraisals, detailed observations and recommendations relating to key risk areas	Core	240

Reporting line	**Function**	**Main activity**	**Role**	**Fte**
GCEO	Group Economic Research	Provides the GEB with advisory and support functions and to co-ordinate cross-divisional economic research efforts	Shared services	27
GCEO	Group Mandates	To manage mandates for group participations and to be responsible for UBS foundations	Added value	10
GCEO	Group Management Support	To support to the GEB and BoD; to organise and manage employee communication	Shared services	32
GCFO	Group Risk Management	To develop the risk policy framework, for setting and monitoring the related risk limits (excluding credit risk limits), to aggregate and assess total risk exposure, to approve valuation models, and to define risk measurement methodologies for submission to the GEB and BoD. Manage the Market Risk Control unit; includes 50% of the joint venture with Group Credit Risk Management	Core	77
GCFO	Group Credit Risk Management	To formulate credit risk policies, to determine methodologies to measure credit risks, to set and monitor credit and country limits, and to manage the business group credit risk control units; includes 50% of the joint venture with Group Risk Management	Core	95

Reporting line	**Function**	**Main activity**	**Role**	**Fte**
GCFO	Group Strategic Analysis	Creates complex business models within the divisions, placing employees internationally to implement and co-ordinate planned objectives. The team also analyses competitors and examines acquisition candidates for the group, providing key decision-making and often working closely with divisional corporate finance teams. The area has evolved into an internal consultancy operation where lt-planning is carried out	Added value	17
GCFO	Investor Relations	Primary contact for institutional investors in UBS shares. The department prepares presentations for investors and arranges road shows. It also meets with analysts and investors on a regular basis both in Switzerland and abroad. Also responsible for preparation of the annual report.	Core	12

Table 63: Corporate centre functions and responsibilities of UBS

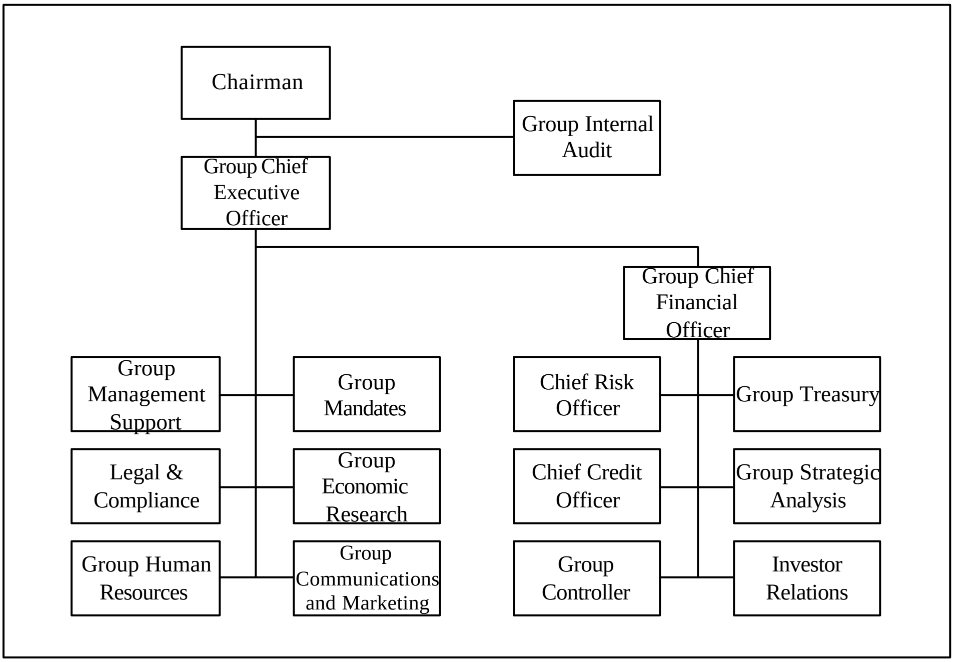


Figure 57: Organisational structure of UBS' corporate centre

UBS has different cross-business group committees, which because of their operational nature are not part of the corporate centre. Because of the group interest of these committees, these are presided by corporate centre delegates (see Table 64).

Cross-business group committees	**Chair**	**Other members**	**Activity**
Group Governance Committee	GCEO	GCFO, Group Controller, GCRO, GCCO, Business group Heads Corporate Governance/Legal and Compliance, Head Group Internal Audit, Head Group Legal & Compliance	Responsible for the coordination of the group's public policy interface with central banks and regulators, for minimizing the group's reputation risk

Cross-business group committees	**Chair**	**Other members**	**Activity**
Group Finance Committee	N/A	Chairmen of Group Risk Committee, Group Controlling Committee, Group Treasury Committee	Responsible for co-ordinating the group's accounting, risk management and control, treasury and financial communications processes
Group Human Resources Committee	CEO	Head Group HR, business group heads HR	Responsible for the definition of human resources policies and standards which contribute to the identification, recruitment, development and retention of high-calibre staff
Group IT Committee	CIO UBS CH	CIO UBSW, Head IT Operations UBSW, Head IT Systems Engineering UBSCH, Head IT User Services UBSCH, Head Architecture & Business Support UBSCH, Head IT Operations UBSCH, COO PB, Head IT PB, Head IT UBSAM Head Investment Clients, Head Corporate Centre Operations	Ensuring group wide coordination of policies and standards in the IT area (standardization, architecture, security, networking, and service level agreements).

Cross-business group committees	**Chair**	**Other members**	**Activity**
Group Communications and Marketing Committee	GCEO	GCFO, Head Group Management Support, Head Investor Relations, Head Regulatory Relations, Head Group Public Relations, Head Group Marketing, Head Group Economic Research, Business Group Reps	Ensuring that communication to all stakeholders, internally and externally, is transparent, accurate, concise, timely and consistent
Group Operations Committee	GCEO	CEO UBSCH, CEO UBSW, CEO PB, COO PB, Head Operations UBSCH, Head Operations UBSW, Head Logistics UBSW, Head Securities Operations UBSCH	Manages functions such as cash accounting, securities trading, custody, operations risk, payments to ensure a single group market interface for currencies and securities group level standards and policies for data mngmnt/OR
Group Risk Committee	GCRO	CFO, CCO, Group Controller, Head Group Insurance Management Liability Risk Control, Head Group Strategic Analysis, Business group CCOs, Head Market Risk Control UBSW, Head Country Risk, Head Risk Process Review	To review the status of implementation and the compliance with the risk framework across all risk categories

Cross-business group committees	**Chair**	**Other members**	**Activity**
Group Controlling Committee	Group Controller	CFO, business group controllers, regional chief accountants, Head corporate controlling & accounting, Head Corporate Center Controlling, on ad-hoc basis CRO, CCO, Head Group Treasury, Head Corporate Center Operations, Head Corporate Tax	Responsibilities include ensuring a group-wide consistent vision of controlling and accounting, policies and principles, decide on the group's planning cycle, decide on methods and procedures for implementation, ensure common controlling language and exploit synergies, ensure timeliness and quality of controlling and accounting process
Group Treasury Committee	N/A	N/A	N/A
Corporate Real Estate Committee	Head of Corporate Real Estate	COOs of the business groups, ad hoc delegates from other units	Responsibilities include establishment and ensuring implementation and compliance of policy, strategy, principles, guidelines and standards, resolving cross business group disputes, ensuring data integrity, facilitation tasks and responsibilities

Cross-business group committees	**Chair**	**Other members**	**Activity**
Legal Structure Committee	Head Corporate Tax	Head Group Treasury, CRO UBS Switzerland, Head Legal, UBS Warburg, Head Legal, UBS Asset Management, Head Legal, UBS Private and Corporate Clients, delegates from Private Equity and corporate centre, Head of Corporate Accounting	Responsibilities include pre-approving the formation of all new legal entities, branches or representative offices, pre-approving of the liquidation, transfer, merger, closure or material change of business purpose of relevant current legal entities, branches and representative offices, ensuring that each relevant legal entity is assigned to a business group, ensuring that all changes to the group's legal structure are made in compliance with relevant laws and regulations and are all properly recorded

Table 64: Cross-business group committees of UBS

c) Corporate centre economics

At the corporate centre, controlling is seen not as a task of corporate centre management but as a task of the controlling department. This means that costs are primarily supervised by Corporate Center Controlling. Only when actual costs substantially differ from budgeted costs, corporate centre management will want an explanation. Corporate Centre Controlling primarily has an advising role to the Group Controller. The mission of Corporate Center Controlling is to deliver client focused state-of-the-art controlling products and processes, including management account reports, integrity of systems structures, and implementation of controlling processes, to corporate centre divisional and sector management to support decision making (UBS, 1999b). As Corporate Center Controlling does not have a complete infrastructure of its own, good working relations are necessary. At UBS, the opinion is that it is unclear how much really can be managed of the corporate centre cost base, due to the nature of the corporate centre, and it seems that cost management in itself is in conflict with the nature of the corporate centre. The corporate centre departments are managed as cost centres, with the notable exception of Group Treasury, which is seen as a profit centre, with strong controls and limits. Performance measurement takes place via key performance indicators and business group' satisfaction. The financial result of the department is less relevant; it is the group result and individual manager performance, which receives most attention. Benchmarking takes place more as an exception, than as a rule. At UBS, the purpose of the business planning process is to provide senior management with the information required to objectively evaluate the strategic factors affecting the firm in general and the corporate centre in particular, in order to achieve and maintain a sizeable and sustainable competitive advantage (UBS, 1999c). During the business planning process, information flows between different organisational partners, be it within the corporate centre, and/or between business groups. This information flow is required to ensure that the business area plans are synchronised. Corporate Center Controlling and senior management co-ordinate the efforts, review the plans as they develop and consolidate these at the business group level. The active involvement of senior management in strategic business plan development generally ensures a high degree of commitment by the organisation. Business plans should cover a period of three years and should be updated whenever material changes occur; Table 65 outlines the business planning process. A bottom-up character can be recognised: 1) business plan on sector level: this business plan is the most comprehensive of all and is the basis for the final corporate centre plan, 2) business plan on area level: this business plan is a summary of the sector plans with the key items and shows the strategies for the Chairman-, CEO- and CFO-areas, and 3) business plan on business group level: this business plan is a summary and shows the strategies for the Corporate Center.

Step	Action
1	Definition of current role, mission and responsibilities as a result of present, realised strategy
2	Examination of business environment in which the sector operates
3	Assessment of the strengths and weaknesses of the sector
4	Development of a realistic, challenging vision through long-term goals
5	Quantification and qualification of goals (critical success factors) and a cross-section of alternative strategies permitting the attainment of these goals; adoption and validation of appropriate strategies

Table 65: Business planning at the corporate centre of UBS

UBS has a well-developed allocation process for costs and revenues (see Figure 58). Direct costs are being charged via service level agreements (SLAs), which are contract-type documents describing interdivisional supply and demand. The goals of this allocation process are:

- Ensure fair and transparent revenue/cost allocation
- Describe and define revenue/cost base and underlying revenue /cost drivers
- Foster understanding of value chain by agreements between provider and recipients
- Establish basis for continuous learning process within the organisation
- Support process to identify and realise inherent revenue and cost synergies
- Foster and deepen co-operation between Business Groups/Business Units and enforce principle of an integrated financial services group by avoiding duplications.

As a management accounting principle, the allocation of corporate centre costs to the business segments is based upon concepts of benefit and controllability. Basically, the business group, which controls the process or is responsible for the logistic bears the cost (UBS, 1999e, p.9). For the year 2000, 16 percent of the total corporate centre operating cost was directly allocated to the business groups (i.e. via SLAs). This means that the business groups receive these cost charges as direct cost, which has an impact on the result of the business group. The result of the business group is linked to managers' compensation, implying that business group management has an incentive to lower that cost. This cost can be lowered in two ways 1) use a lower volume of services: this is possible in changing times or by lowering the need for the service and 2) negotiate a lower price: generally speaking, the price paid, which is the unit cost allocated, is the cost of the service. By exerting pressure on the corporate centre by means of external benchmarking or by being able to produce the service in-house at lower cost, the corporate centre is incentivised to lower its cost and think of new and lower cost ways of producing that service. A capped amount of 10% of the indirect costs are allocated based on headcount and resulted in the key as shown in Table 66. Although this allocation does have effect on the net result of the business group this has no impact on business group managers' compensation. The incentive to produce these services at lower cost is with corporate centre management.

Corporate Center	UBS Asset Management	UBS Switzerland[1]	UBS Warburg
4%	6%	48%	42%

Table 66: Indirect cost allocation of the corporate centre at UBS

[1] Of which 18% for Private Banking and 30% for Private & Corporate Clients

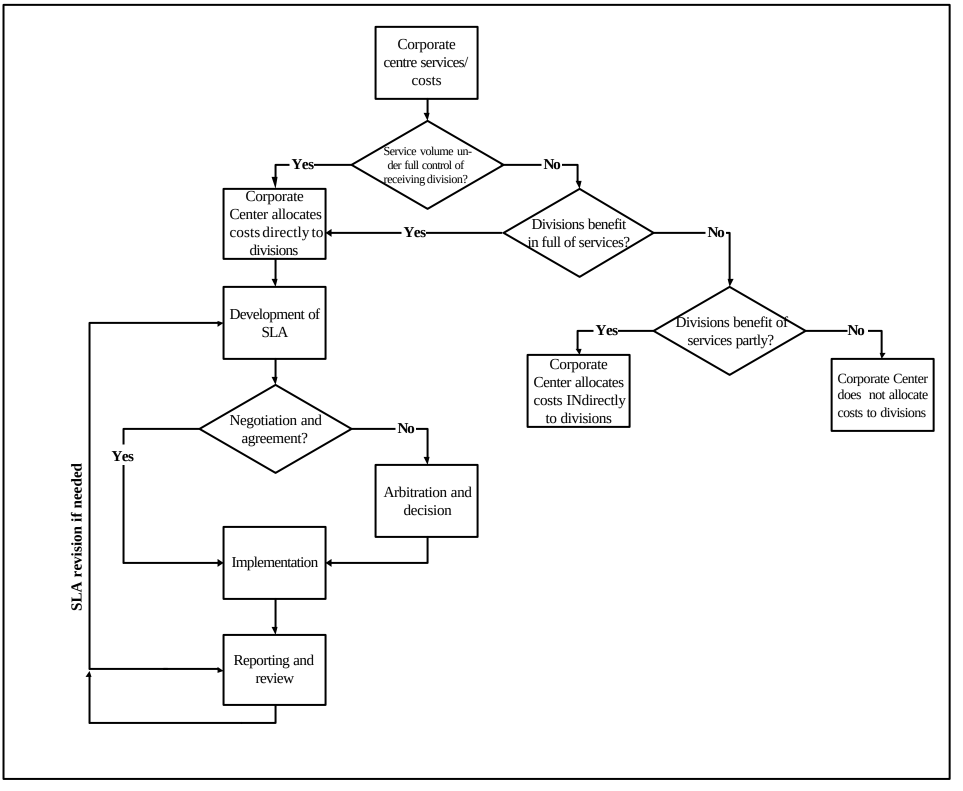


Figure 58: Allocation process in UBS

3. Conclusion

The corporate centre of UBS is a well-established business entity in the group. Table 67 summarises the conclusion on the corporate centre of UBS. In 2000, the corporate centre resembled the ICCC in terms of organisation and transparency. However, there seems to be contradiction between the role, which the corporate centre is said to play, and which it plays in reality; this contradiction may result in confusion and loss of efficiency and effectiveness. Mixture of management styles and coordination instruments can lead to low transparency and the perception that the corporate centre does not have a clear mission. Although controlling seems active, the lack of value measures and market replication might result in that the synergy potential might not be reached. The staffing level seems well targeted and fulfils a basic premise.

Characteristic	**Actual situation in 2000**
Conglomeration	"American/German" variant shifting to weak form of conglomeration
Nature of corporate centre	
Role and functions	Core, added value, and shared services; functions match ICCC as far as core and added value are concerned
Coordination instruments per function	Mixed culture, role standardisation, plans, goals, budgets
Contribution, value-based management and operational risk	Potential for contribution present, implementation unclear; value, with focus on multiple stakeholders, and operational risk orientation present, implementation unclear
Management and organisation of the corporate centre	
Solving managerial issues	Service level agreements and committees present; relative lower transparency leading to higher influence costs, solution for moral hazard unclear
Corporate centre management style	Mixture of Strategic Planning, Strategic Control and Financial Control
Staffing the corporate centre	Staffing level (986 fte, 1.4% of group), little bit above lower of 922 fte, 1.3% of group (upper limit is 1478 fte, 2.1% of group).
Corporate centre economics	
Financial orientation	All departments are cost centres, Group Treasury is a limited profit centre; corporate centre controlling focused and active
Approximation of value and costs	Value measurement not performed, cost management performed, non-financial performance measurements not present, benchmarking unclear
Corporate centre cost allocation	Cost allocation, based on cost prices, performed via service level agreements and maximum 10% via indirect allocation

Table 67: Conclusion on the corporate centre of UBS in 2000

V. Conclusion from the case studies

From Table 68, we recognise that the financial conglomerates in the case studies show a tendency to move to the weak form of conglomeration as regional and intransparent structures are reorganised in divisions, focused on product/market combinations, and a corporate centre. The main difference between the financial conglomerates lies in the presence or absence of an extra management layer between a major division and the executive board. This is illustrated by the example of Private Clients and Asset

Management, which are separate organisational units reporting to the same executive in AA and DB, but reporting individually to the executive boards of CSG and UBS.

	Weak form	**AA**	**CSG**	**DB**	**UBS**
Divisions	Holding Company	Corporate Centre	Corporate Centre	Corporate Centre	Corporate Centre
	Securities (general)	Wholesale Clients	Investment Banking	Corporate and Investment Banking, Corporate Investments	Investment Banking
					International Private Banking
	Banking	Consumer & Commercial Clients	Retail Banking & Insurance	Personal Banking (part of PCAM)	Retail and Corporate Banking
	Insurance				
		Private Clients & Asset Management	Private Banking	Private Clients & Asset Management (PCAM)	Swiss Private Banking (together with Retail and Corporate Banking)
			Asset Mngmnt		Asset Management
Not attributed	Various	AA Lease Holding	Various	DB Services, Corporate Investments	Various

Table 68: Organisation structures of the case studies

Supported by historical publications on the case studies (ABN AMRO, Nawas, 1995; Credit Suisse Group, Jung, 2000; Deutsche Bank, Deutsche Bank, 1999, 2001, and UBS, Rogge, 1997), a move from the original centralised forms to the weak form of conglomeration of the firms is confirmed (Figure 59). This move is not complete and results in that the firms are in between variants. Difficult organisational transformation, paired with motivational issues, results in inefficiencies. This may also lead to incomplete governance, allowing for adverse consequences.

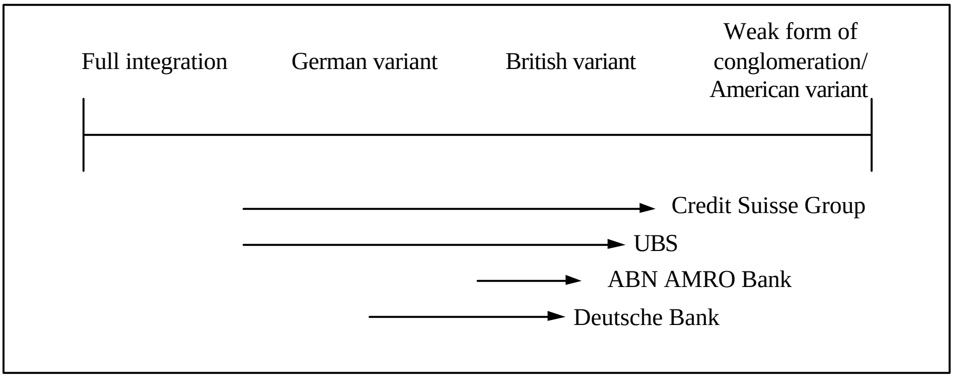


Figure 59: Case studies on the continuum of conglomeration

Of the case studies, three out of four use shareholder value as tool for performance measurement (DB is the exception). To what extent value-based management, including an institutionalised controlling cycle, is implemented in the case studies, is difficult to say. At least, we can state that top management is aware of the shareholder value premise. AA, CSG and UBS use shareholder value to serve all stakeholders. At DB, shareholders are seen as one group of stakeholders out of four major stakeholders. Table 69 shows comparisons of the departments in the corporate centre according to the Integrated Corporate Centre Concept (ICCC) with the case studies. Although there are differences in reporting lines, the organisational structures of the case studies indeed match the organisational structure of the ICCC to a large extent.

ICCC	**AA**	**CSG**	**DB**	**UBS**
Core				
Group Finance & Control	Group Finance	Group Accounting & Reporting	Group Controlling	Group Controlling
Group Human resources	Group Human Resources	Human Resources	Group Human Resources	Group Human Resources
Group Tax	Fiscal Affairs (part of Corporate Affairs)	Tax	Corporate Tax	Corporate Tax (part of Group Controlling)

ICCC	AA	CSG	DB	UBS
Group Legal & Compliance	Corporate Affairs (incl. Legal & Compliance)	Legal Services	Group Legal, Group Compliance	Legal and Compliance
Group Audit	Group Audit	Audit, Security & Investigation	Group Audit	Group Internal Audit
Group Public Relations	Corporate Communications (incl. Investor Relations)	Group Communications, Investor relations	Group Communications (together with Group Marketing, Group Press	Group Communications (together with Group Marketing), Investor Relations
Group Risk Mngmnt	Group Risk Management	Risk Mngmnt	Group Risk Management Group Risk Board, Office of Vice-Chairman	Group Risk Management, Group Credit Risk Management
		Management Support, Logistic Support, Corporate Secretary	Corporate Centre Coordination	Group Management Support, Corporate Centre Coordination (part of Group Controlling)
Added value				
Group Development	Corporate Development	Corporate Development & Finance, Special Advisory	Corporate Development	Group Strategic Development
Group Marketing			Group Marketing (together with Group Communications)	Group Marketing (together with Group Communications)
Group Treasury	Group Asset & Liability Management	Funding	Group Treasury	Group Treasury
Shared Services				
	Group Information and Communic. Technology	Group Information Technology Office		

ICCC	AA	CSG	DB	UBS
	Economic Research (part of Corporate Affairs)		Group Economic Research	Group Economic Research
	EU-Liaison Office	Public Affairs, Executive Relations, Foundations Corporate History		Group Mandates

Table 69: Comparison of case studies' departments

What is striking, is that 1) functions according to ICCC are largely present, but the treasury activities performed in the Corporate Centre are limited to funding, 2) implementation of value-based management and operational risk management is unclear, 3) coordination instruments are sometimes mixed and not focused, 4) the moral hazard problem is not solved and transparency is sometimes low, 5) there is no unambiguous choice for a single management style, 6) staffing is lower than the benchmark allows, 7) there is a cost centre orientation and only CSG has a value measurement, and finally 8) cost allocation is performed, but remains difficult to initiate and implement. Focussing on the Group Treasury department, the cases reveal that the activities of this department are limited to funding, which can be relevant for the ICCC-model. Also, the Group Treasury departments in the cases are managed as cost centres, without a profit orientation. Capital market transactions to hedge the group balance sheet positions (i.e. nullifying currency-, interest rate- and duration mismatch) should be labelled as ALM-transactions and performed by a trading desk. These transactions are driven by risk considerations, implying that *profits might even be foregone*. The execution of these trades is performed at divisional trading desks. These trading desks are normally part of a for-profit operation in a division and receive orders from the Corporate Centre, where the decision-making body, i.e. committee, is a larger body than just the Group Treasury department. The transactions should have market prices, in order to create an understanding of the true *insurance premium* needed to cover group-level risks and the true risk-return characteristics, and provide for proper incentives. The result of these ALM-transactions should be shown separately in the results of the Group Treasury function. Specifically focussing on management styles, we recognise that the softer factors in the case studies match the ICCC to a lesser extent. Table 70 and Figure 60 show the individual cases[1].

	ICCC	AA	CSG	DB	UBS
Strategic Control					
Decentralised profit centres, Divisional coordination	Y	Y	Y	Y	Y
Extensive strategic planning process	N	Y	N	Y	Y
Business autonomy	Y	Y	Y		Y
Long- and short-term criteria	Y	Y	Y	Y	Y
Tight controls	N	Y	N	Y	Y
Financial control					
Separate profit centres	Y	Y	Y	Y	Y
Budgetary planning	Y	Y	Y	Y	Y
Business autonomy	Y	Y	Y		Y
Short-term criteria	N	N	N	Y	Y
Tight controls	N	Y	N	Y	Y
Strategic Planning					
Complex, co-ordinated structure	N	N	N	Y	Y
Extensive strategic planning process	N	Y	N	Y	Y
Strong central leadership	N	Y	Y	Y	N
Long-term criteria	N	Y	N	Y	Y
Flexible controls	Y		Y		

Table 70: Match of the cases and the ICCC with standard management styles

Presented differently in figure 61, we see that Credit Suisse Group matches the ICCC-management style best followed by ABN AMRO Bank, UBS, and then Deutsche Bank. Although attempts are made, it seems difficult to decide on and implement the ICCC unambiguously. This might lead to an ineffective corporate centre. There may be organisational obstacles within the financial conglomerates preventing reaching a dynamic state, oscillating around the ideal corporate centre. These obstacles can include the perception that implementing the ICCC is not needed or possible, conflicts of interest between managers, unawareness of the importance of a well-functioning corporate centre, and a focus on only keeping costs low. A clear implementation of the ICCC would enable an effective and efficient corporate centre reaping the benefits of synergies, which would allow financial conglomerate structures to prove their worth. The complete analysis is summarised in Table 71.

[1] The ICCC states that a condition should be present; if the case study matches this, we see a Y; if the ICCC states that a condition should be absent and this condition is matched, we see a N. In other cases there is a mismatch (equal weighing of characteristics assumed).

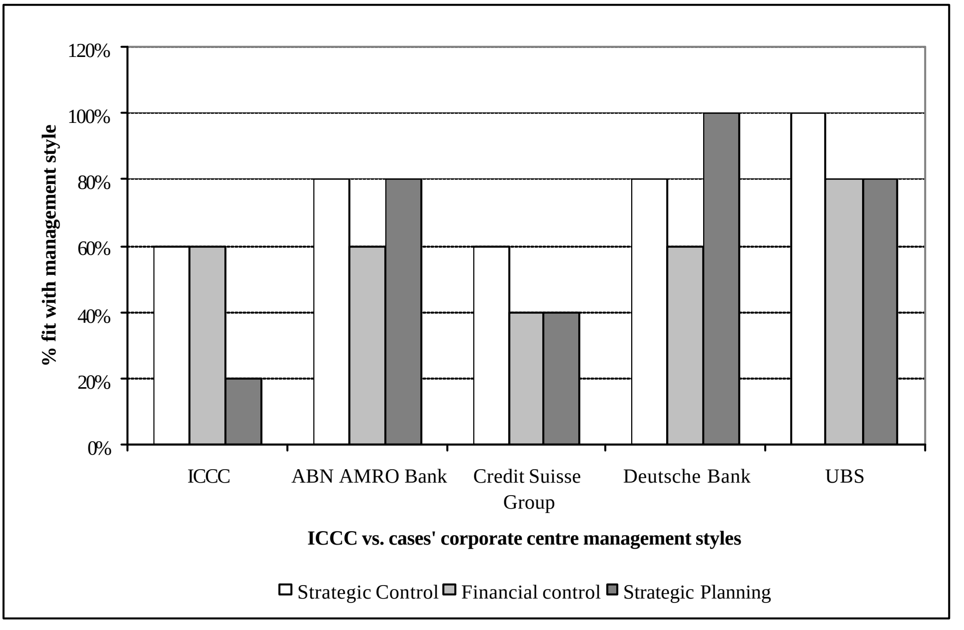


Figure 60: Match of the cases and the ICCC with standard management styles

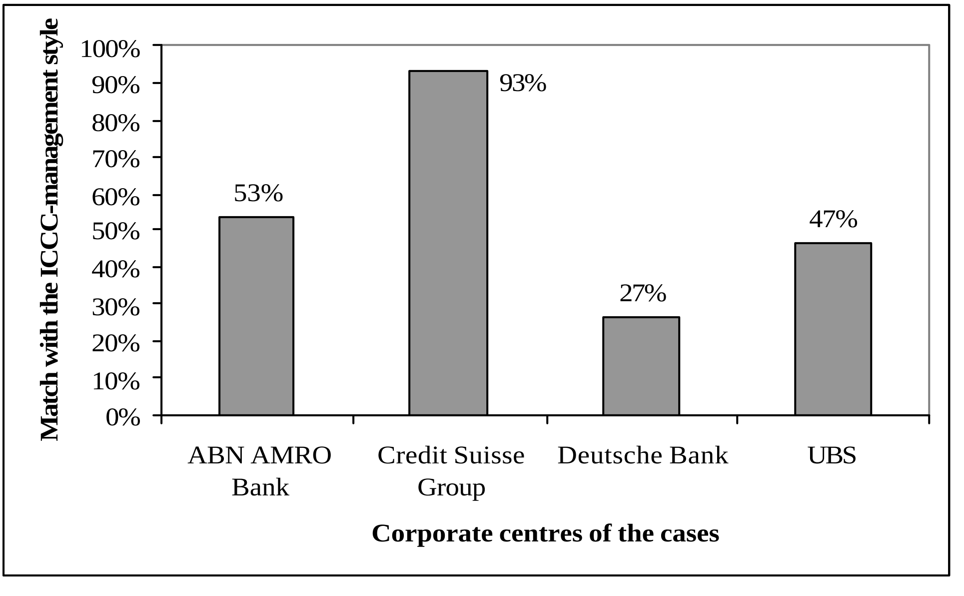


Figure 61: Cases' management styles vs. the ICCC

Characteristic	**ABN AMRO Bank**	**Credit Suisse Group**	**Deutsche Bank**	**UBS**
Conglomeration	"German/British" variant shifting to the weak form of conglomeration	Weak form	"German" variant shifting to weak form of conglomeration	"American/German" variant shifting to weak form of conglomeration
Nature of corporate centre				
Role and functions	Primarily core and added value, functions almost match ICCC in full; outsourcing not seen as option	Core, added value, and shared services; functions match ICCC only in part	Core, added value, and shared services; functions match ICCC as far as core and added value are concerned	Core, added value, and shared services; functions match ICCC as far as core and added value are concerned
Coordination instruments per function	Focused role standards, plans, goals, budgets	Focused and effective culture, role standards, plans, goals, budgets	Mixed role standards, plans, goals, budgets	Mixed culture, role standards, plans, goals, budgets
Contribution value-based management and operational risk	Potential for contribution present, implementation unclear; value and operational risk orientation present, implementation in unclear	Potential for contribution present, implementation missing; value and operational risk orientation present, implementation unclear	Potential for contribution present, implementation unclear; value, with focus on multiple stakeholders, and operational risk orientation present, implement unclear	Potential for contribution present, implementation unclear; value, with focus on multiple stakeholders, and operational risk orientation present, implementation unclear

Characteristic	ABN AMRO Bank	Credit Suisse Group	Deutsche Bank	UBS
Management and organisation of the corporate centre				
Solving managerial issues	Performance contracts and committees are set up or already active; transparency improves to keep influence costs low; solution for moral hazard unclear	Performance contracts present; very few committees, transparency keep influence costs low, solution for moral hazard unclear	Service level agreements and committees present; relative lower transparency leading to higher influence costs, solution for moral hazard unclear	Service level agreements and committees present; relative lower transparency leading to higher influence costs, solution for moral hazard unclear
Corporate centre management style	Coming from strategic control to financial control, equilibrium not reached yet	Financial control	Mixture of Strategic Planning, Strategic Control and Financial Control	Mixture of Strategic Planning, Strategic Control and Financial Control
Staffing the corporate centre	Staffing level (650 fte, 0.6% of group) below lower limit of 1,493 fte, 1.3% of group (upper limit is 2,394 fte, 2.1% of group)	Staffing level (824 fte, 1.0% of group) below lower limit of 1,045 fte, 1.3% of group (upper limit is 1,675 fte, 2.1% of group)	Staffing level (879 fte, 0.9% of group), below lower limit of 1,275 fte, 1.3% of group (lower limit is 2,045 fte, 2.1% of group)	Staffing level (986 fte, 1.4% of group), little bit above lower of 922 fte, 1.3% of group (upper limit is 1,478 fte, 2.1% of group)
Corporate centre economics				
Financial orientation of the corporate centre	All depts are cost centres, corporate centre controlling unclear	All depts are cost centres, corporate centre controlling focused and active	All depts are cost centres, corporate centre controlling focused and active	All depts are cost centres, Treasury is a limited profit centre; corporate centre controlling focused and active

Characteristic	**ABN AMRO Bank**	**Credit Suisse Group**	**Deutsche Bank**	**UBS**
Approximation of value and costs	Value measurement not performed, cost management unclear, non-financial performance measurements not present, benchmarking unclear	Value measurement performed, cost management performed, non-financial performance measurement not present, benchmarking unclear	Value measurement not performed, cost management performed, non-financial performance measurement not present, benchmarking unclear, project scorecard implemented	Value measurement not performed, cost management performed, non-financial performance measurement not present, benchmarking unclear
Corporate centre cost allocation	100% Cost allocation performed via performance contracts, practice of allocation procedure unclear	78% Cost allocation, performed via service level agreements, process and effectiveness unclear	100% Cost allocation, based on market prices, performed via service level agreements	Cost allocation, based on cost prices, performed via service level agreements and maximal 10% via indirect allocation

Table 71: Comparison of the corporate centres of AA, CSG, DB and UBS in 2000

C. General conclusion and outlook for further research

As indicated in the general introduction: there is a specific shared need for theories for strategic renewal in the financial services industry, and although four case studies are not significant for a statistical analysis, we find that financial conglomerates are indeed looking for improvement of their governance through the corporate centre; this also becomes increasingly important in the eyes of the regulators. This thesis deals with that issue and proposes an integrated corporate centre concept for financial conglomerates (ICCC) taking into account the dynamics and complexity of the financial services industry, the forming of financial conglomerate structures, value-based management, operational risk management, strategic management and organisational economics. The ICCC is a dynamic concept, changing with external influences and has three interacting core elements: nature of the corporate centre, corporate centre management and organisation, and corporate centre economics. Management theory, as applied to the financial services industry, is far from complete. This study can form a basis for further research (see also Figure 62). Interesting would be:

- A statistical analysis of more financial conglomerates on the implementation of the ICCC: this would raise questions on barriers to implementation, would yield in an increasingly useful benchmark, and would allow for further model refinements
- A detailed comparison of corporate centre departments and their peers, e.g. in consulting firms, on the external market: this would yield an insight to what extent and how corporate centre departments could be outsourced
- A theory on detailed performance indicators per corporate centre function: this would lead to an increased understanding of corporate centre' value drivers
- An analysis to what extent corporate centres add value to their financial conglomerates using the Residual Value-method: this would lead to insights to what extent financial conglomerates are value-creating organisational structures
- As the Residual Value-method results in a value for corporate centre creation, development of a market-based replication of the corporate centre, especially of the needed economic capital and the cost of equity, i.e. via a peer comparison with professional services firms, could lead to an understanding of measuring corporate centre profits similar to a professional services firm
- Further application of management theory in financial services, especially aimed at fields such as ISO-style quality management, non-financial performance indicators and non-traditional risk management: this would support the understanding and professionalisation of the management of financial conglomerates.

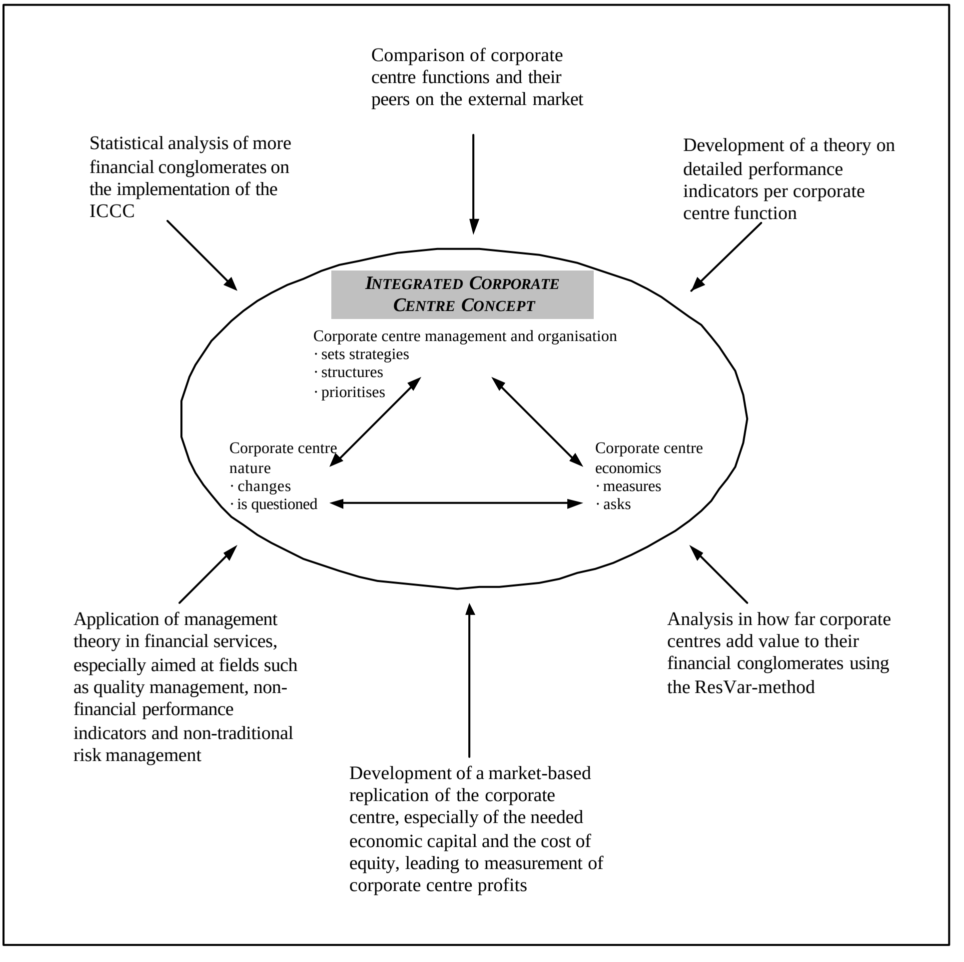


Figure 62: Examples for further research

SUMMARY

In part 1, we discuss 1) the fundamental changes in the financial services industry, 2) financial conglomerate structures and 3) value-based-management. These are core components for understanding the challenges and intentions of corporate level management of financial conglomerates.

The financial services industry, financial conglomeration and value orientation

In the **first** chapter, we highlight the major trend of *consolidation* in the financial services industry. This trend is most visible in business publications, and interacts with other trends. Financial conglomerates grow due to the fact that size is believed to be the answer to many difficulties. As consolidation continues and non-traditional financial service activities enter into financial service activities by financial services firms, the safety net expands, thereby imposing additional costs on the financial system. At the same time, regulators are looking for new ways of supervision. New capital requirements for credit, market and operational risk (Basel II), mandatory subordinated debt, a better supervisory structure and guidelines for corporate governance are all under development. The expectation is that, after a period of focus on model-based risk management, regulators will now be increasingly focusing their attention at management processes. Various trends contribute to the consolidation drive. For one, *technological progress* is very important as technology erodes entry barriers; financial services firms face pressures from a wider and more diverse range of competitors. New technologies support the development of *new financial products* and these products create new challenges for financial services firms. These products increasingly are capital-market based instead of straightforward savings- or credit facilities. Well-developed economies tend to shift from a *bank-based* system towards a *market-based* system in which the majority of the financing need is provided for by the capital market. While regulators attempt to supervise the financial system, *deregulation* leads to increased competition with margins being driven down and requiring scale economies. This dynamic is complemented by the drive to eradicate *excess capacity* in the global financial services industry. At the same time, and perhaps resulting from these industry changes, the lines of the financial services industry are blurring. Non-financial services firms are making inroads in the financial services industry: we call this *near-banking*. A specific form of near-banking is *in-house banking*: non-financial firms perform several financial activities for themselves. Another special case of near-banking is *internet banking*. Innovations in communication and information technology has led to the increased possibility of total process automation of searching, buying, selling, producing and distributing and introduces the notion of *contract banking*, in which a complete package of services for a client consists of the management of contracts for those products individually. Financial services firms are reacting by setting up separate internet divisions, partnering with technology-oriented firms, and forming alliances with firms in- and outside of the financial services industry.

In the **second** chapter, we discuss financial conglomerate structures. The financial services industry is made up of many types of participants of which financial conglomerates are often the most visible. There are four different prototypes of financial conglomerates recognised, which range from almost complete to very loose integration. Financial conglomerates are formed when management feels that this structure is best suited to achieve maximum synergies: economies of scope and scale in production and sales of financial services. Synergies, from the firm's perspective, can be reached in improved client management, when distribution channels are used for more products, simultaneous marketing of products, use of information for different products and the reduction of portfolio risk. From the client's perspective, synergies may exist in the procurement and use of a complete financial services package instead of individual products. There are diseconomies of scope, which may jeopardize the advantages of the financial conglomerate structure. We recognize regulation and compliance costs of a large bureaucracy, complexity of managing several businesses, lack of trust in the use of client' information and decrease of transparency as a result of reduction in market discipline, as potential issues.

As we see in the **third** chapter, in dealing with environmental turbulence and the optimisation of the structure, financial conglomerates focus on the creation of shareholder value in all their activities. Functional excellence is not the only pre-condition for success, increasingly a client focus, reducing x-inefficiency, and company repositioning in the (financial services) industry becomes important. There are various methodologies to measure shareholder value creation, which in essence is about achieving a return on capital higher than its cost. Six characteristics determine to what extent a financial conglomerate is value-oriented: performance drive, value-base, low cost, self-reinforcing processes, two-way communications, and bottom-up and top-down management. The company organisation for value-based management is the *profit centre*. Profit centres are organisational units, which are responsible for their own results and are able to decide independently from each other. Adjacent to the profit centre concept is *lean banking*, which focuses on the optimisation of operational processes through well-known concepts from industrial management. Measuring the results of value-based management is of utmost importance on both corporate and divisional levels, as well as within divisions. Value controlling measures the gap between the market value of the firm and its potential, and supports divisions with the implementation of value-enhancing strategies. Instruments for value-controlling include the Matched Funds Transfer Pricing concept, Activity Based Costing, and Process-oriented Standard Direct Cost Accounting. The non-financial dimension is assessed with the Balanced Scorecard, which can be seen as a system of operational measures (i.e. ratios), which are connected to each other via cause-and-effect relationships. One important determinant of shareholder value creation is lowering risk, as this results in a lower firm cost of capital. Financial conglomerates, though, accept risk to generate profits. For financial conglomerates there are five risk categories: systemic risk, company-specific strategic risks, market risk, credit risk, and operational risk. *Operational risk* is the potential for any disruption in the financial conglomerate's (operational) processes and includes reputational risk, legal enforcement of contracts and claims, possibly having a severe impact on the financial conglomerate's perception in the market, share price devaluation and a loss of standing. Operational risk seems to be more in the management realm than in accounting.

Discussion of the corporate centre

Given that we now understand the major governance issues for financial conglomerates: fundamental changes in the financial services industry, financial conglomerate structures and value-based and (operational) risk management, we discuss the main governance body of financial conglomerates in part 2: the corporate centre. We focus on its nature, management and organisation, and economics. In the **first** chapter, we discuss (de-) centralisation, roles and contribution of the corporate centre. On the continuum between centralisation and decentralisation, we distinguish between five statuses: core, policy, matrix, service, and autarchy. These statuses have different characteristics and are appropriate in situations of different complexity and environmental dynamics. In the ranking of increasing coordination, we recognise the following instruments: company (sub) culture, role standardisation, self-management, plans, programs, and personal instruction. In conjunction with issues of decentralisation and coordination is the issue of influence of the corporate centre, which tends to be highest in the general planning areas, and lower in the functional. There are three requirements for value creation by the corporate centre: 1) opportunity, 2) skills and resources, and 3) the degree of understanding by the corporate centre. Opportunities arise from an imperfect fit between divisions and the environment. The following five types of opportunities are distinguished: build, stretch, link, leverage and portfolio development. One way to realise the synergy potential is to identify affinities and critical interrelationships within the group, develop and analyse value chains per division and look for common characteristics, formulation of a strategy in coordination with corporate and division strategies with goals supporting the pursuit of interrelationships, and configuration of the synergy activities.

In the **second** chapter we focus on the management and organisation of the corporate centre. The form of the corporate centre is decreasingly determined by historical and cultural differences and increasingly by industry trends. Further, when a firm is active in a regulated industry, such as the financial services industry, the corporate centre has to take special influences into account: (quasi) government supervision introduces additional administrative overheads, and the lack of competition associated with operating in regulated industries tends to permit higher costs. Organisational economics highlight other managerial issues in financial conglomerates: the agency problem between corporate centre and divisional managers, moral hazard, coordinating costs, the tension between coordination and organisational design, motivation problems, and costs for influencing (ensuring correct distribution of costs and revenues). These issues can be dealt with by focusing on minimizing costs and eradicating inefficiencies. Corporate centres evolve as a result of change in the overall size of the company, change in the level of influence corporate managers have over divisional decisions, change in the level of services provided to the business divisions, and concern about the cost-effectiveness of the corporate centre. In managing financial conglomerates, three corporate centre management styles can be distinguished: Strategic Planning, Strategic Control, and Financial Control. Five tradeoffs, leading to a specific style, can be identified: leadership versus autonomy, coordination and co-operation versus clear responsibilities and accountability, thorough analysis and planning versus entrepreneurial speed and responsiveness, long-term strategic targets versus short-term financial targets, and flexible strategies versus tight controls. In designing a corporate centre, it is useful to start with the *core* role. This is a matter of ensuring that all corporate obligations can be professionally discharged. The *second* step is to identify the major (intended) sources of added value by the corporate centre: the *added value* role. Companies that can find no major value added opportunities should consider to demerge, or to reduce the corporate centre to the core role only. The *third* step is to focus attention on shared services, which may or may not be placed in the corporate centre: the *shared services role*. Corporate centre functions that outsource tend to employ fewer staff. Notwithstanding this fact, they are not as small as might be expected; as outsourcing increases, the net positive effect in terms of staff levels decreases. On average, financial services firms have three to four times the corporate centre staff as manufacturing companies of comparable sizes. Although companies in the financial services industry can have many linkages between divisions, it is unlikely that this accounts for the larger corporate centre by itself. The level and nature of corporate centre functional influence is a driving factor in shaping the number of corporate centre staff. The study provides for a calculation model on core role staffing.

In the **third** chapter, we focus on corporate centre economics. As an organisational unit with its own mission, strategy and goals, control is indispensable. Control of corporate centre costs should be initiated at the highest level. Corporate centre's staffs do not have the direct profit motivation that exists in commercial divisions. One way to control corporate centre cost and to develop a profit motivation in the corporate centre is to implement the profit centre concept. This requires the corporate centre to have revenues; these revenues can be (replicated) market-based allocations (transfer prices). General corporate centre cost is to be supervised by a special appointed executive, the corporate centre controller. The purpose of corporate centre controlling is to limit costs of the corporate centre, and to develop efficiencies in the performance of corporate centre functions, similar to those that in divisions. The functions of planning, control and supervision of corporate centre costs can be delegated only to a management level superior to the corporate centre functions. This is virtually untenable unless it receives the full support of the most senior level management. It is in the areas within the corporate centre that tendencies toward empire building can be quite pronounced, making solid control necessary. Planning and control is an ongoing loop in which both activities are continuously performed and intertwined. Reducing corporate centre costs can be difficult as corporate centre services are often of an intellectual nature, have a high level of complexity and can be non-repetitive. Also, if no attempt is made to compare corporate centre departments to a, possibly replicated, external market, there will be no competitive pressure to keep costs low. Last but not least resistance exists with corporate centre managers, often based on historical issues, bad experiences or overrating of their own capacities. Caution must be expressed here: there does not appear to be any support for the idea that financial conglomerates with smaller corporate centres have greater financial success. The corporate centres of firms that had profitability and shareholder return above the average for their country were, in terms of staffing, around 20 percent larger than those of firms with below average profitability.

In addition to financial measurement, benchmarks representing value drivers, provide in instruments to measure (improvements in) performance and to identify problems when goals are not reached. Ideally, control measures should be objective, complete and responsive. Cost allocation, a widespread practice, comes into play to when the corporate centre transfers its cost to divisions to recognise (virtual) corporate centre revenues. The purposes for cost allocation are to make economic decisions for resource allocation, to motivate managers, to measure income and assets for reporting to internal and external parties, and to justify costs. There are six criteria for cost allocation: cause-and-effect, benefits received, fairness or equity, ability to bear, independence of cost objectives, and neutrality. Allocation functions for shared services include: transaction, planning, to supply prices to be used in planning processes, management, result allocation, motivation, and influence of behaviour. Although allocating core role costs through Activity Based Costing could increase transparency, allocating these costs is inevitably arbitrary as this seeks to divide something, which is almost indivisible and incorrigible, meaning that, although transparent, they cannot be proved correct or incorrect. The marketplace provides a process for services. The nearest equivalent that can be offered in respect to corporate centre services is that the total cost of any item of controllable corporate centre cost must be authorised by and charged to the person consuming that item. Price setting for corporate centre cost allocation can be done in three ways: 1) (replicated) market prices, 2) cost prices, and 3) negotiated prices.

Development and application of an Integrated Corporate Centre Concept for Financial Conglomerates

In part 3, we arrive at the integrated corporate centre concept for financial conglomerates (ICCC). This ICCC is a synthesis of parts 1 and 2 and focuses insights of those parts. The concept is an addition to the literature on management issues in financial conglomerates and suggests an approach to deal with governance issues. It also forms a comprehensive benchmark for financial conglomerates' corporate centres and as such will be used to evaluate corporate centres of four financial conglomerates. The ICCC consists of three core elements, which interact with each other: corporate centre nature, corporate centre management and organisation, and corporate centre economics. The case studies are the corporate centres of the financial conglomerates ABN AMRO Bank, Credit Suisse Group, Deutsche Bank, and UBS, studied during 2000. In the **first** chapter we present the ICCC. As financial conglomerates are confronted with similar industry changes and show herd behaviour they move towards the same conglomerate organisational form. As more efficiency in production and consumption of financial services can and should be reached to cope with the industry changes, financial conglomerates more and more separate their different activities, leading to relative independent divisions and sub-divisions, which are organised around certain product-market combinations. Increasing separateness within financial conglomerates can be recognised as a move towards the American variant of universal banking. The distinction between different variants of universal banking becomes a dichotomy between stronger and weaker forms of conglomeration; the American variant then is the *weak form* of conglomeration. Partially, the move of financial conglomerates towards the weak form of conglomeration from more centralised structures results in the creation of the corporate centre as an organisational unit where the executive board and specific staff departments reside. For the corporate centre the basic premise must be to decentralise activities to divisions if they do not have a group mission; activities with a group mission should remain in the corporate centre. Those operational and non-strategic activities, which would benefit from aggregation resulting in the ability to reach scale economies, should be centralised in the financial conglomerate where the centralisation conditions are the best, most probably outside of the corporate centre. These shared services could then compete with outside suppliers. A separate analysis would be necessary to determine if outsourcing of these services could make sense in terms of product quality and costs. We propose to reserve two roles for the corporate centre, but note though that corporate centre departments can show elements of both roles and even might have shared service components. These roles are *core* and *added value*. If senior management thinks necessary, the corporate centre can perform a *shared services* role. However, if there is no strategic need, then these shared services should be placed outside the corporate centre: we propose to principally exclude shared services of the corporate centre and judge on inclusion on a case-by case basis. The core role takes place in the *core* and *policy statuses*: centralisation will take place. The added value role takes place in the *policy* and *matrix statuses*: decentralisation will take place. Corporate centre influence is mostly general and less functional in nature, although the latter is not completely out of the scope of the corporate centre. We propose to include Group Finance & Control, Group Human Resources, Group Tax, Group Legal & Compliance, Group Audit, Group Public Relations, Group Risk Management, Group Development, Group Marketing, and Group Treasury.

In the study we show which departments are affected by specific environmental dynamics. The coordination instruments of the corporate centre vary by function, but we recognise that, depending on its status (core, policy, and matrix) all instruments, such as personal instruction, programs, plans, self-management, role standardisation and (sub) culture, can be appropriate. The contribution of the corporate centre in a financial conglomerate therefore lies in supporting the growth of the business by repositioning (build proposition), and by reinventing the group by reshuffling of businesses with different characteristics (portfolio development proposition). Also, the corporate centre can support divisions in becoming more efficient by using resource allocation in a restricted way (stretch proposition). Perhaps the most important potential contribution of the corporate centre is the capability of the corporate centre to facilitate synergies (link and leverage propositions) As value-based management and operational risk management are becoming important issues for financial conglomerates, these issues are significant for the corporate centre in two manners: 1) insofar as the corporate centre departments perform a group task, they should promote and integrate value-based management and operational risk management in all their services offered to the divisions, and 2) the corporate centre departments themselves should implement value-based management and operational risk management in their own processes. In the study we propose scoring tables for measuring value-based and operational risk management. We have identified six problems of the corporate centre in governing a financial conglomerate. The *agency* problem between the corporate centre and the divisions can be solved using performance contracts. *Moral hazard* can be avoided if the incentive structure of managers is consistently symmetrical. The *coordination* problem can be tackled by forming formal communication channels while at the same time adjusting the compensation systems to reflect the extra effort and result from these communications. Having a detailed and well-accessible information system provides a tool to deal with difficulties in *organisational design*. Incentive systems, which take individual motivation in account, should support *motivational issues*. A high level of transparency ensures that *influence costs* remain limited. On the continuum between the strategic planning and financial control management styles, the ICCC-management style should be positioned between *strategic* and *financial control*. In this way, the corporate centre fits the weak form of conglomeration. The emphasis is on managing multiple separate profit centres, each with relatively independent responsibilities. In the strategic review process, the corporate centre can challenge divisions, especially where synergies are concerned. The planning process is focused on target agreements rather than on the means. A tight control system ensures strong incentives for the divisions to deliver. Resource allocation is similar to the mechanisms in the capital markets, however a longer perspective is chosen than short-term profits. Decentralised organisation structures should overlap in the sense that committees are formed in which synergies can be explored. These committees should be chaired by representative divisional rotation. As detailed long-term strategic planning becomes increasingly difficult, the focus has to be put more on the mid-term with short-term indicators. Strategy development should take place in the divisions <u>and</u> on a group level in the corporate centre. Although the level of detail should not be too high, the strategic plans should result in financial projections. Divisions have far-reaching autonomy within the stated mission and central policy objectives of the group, although they have to take into account that corporate centre functions might need certain divisional input. Controls should always be such that results can be compared to competitors and other divisions. In addition, for the corporate centre, benchmarking should yield useful insights.

A staffing calculation model gives a good indication how the core role of a corporate centre can be staffed. As the financial conglomerate grows, in terms of headcount, the corporate centre grows slower, which points to scale effects. Financial conglomerates increasingly have more specialised divisions; this can be understood as an increase in the transparency and understanding of the level of diversification. This implies that more emphasis should be put on financial measures than strategic measures for assessing a division's performance. Principally, the corporate centre should be managed as a profit centre. This means that the behaviour of corporate centre managers and staff should be modelled as if the department was a market participant in its own right. Cost allocations out of the corporate centre can be seen as revenues. However, if revenues prove unable to be calculated, the revenue side of the corporate centre department can be expressed in market-based financial or non-financial benchmarks, expressing efforts and results of the corporate centre (department).

The corporate centre should have an appropriate controlling organisation and mandate. Similar to the cost development of the corporate centre to the cost development of the financial conglomerate as a whole, if the corporate centre controller (CCCL) has the proper organisation and mandate, the controlling function would grow less fast than the corporate centre. This mandate should encompass projections, revenue and cost budgeting, planning, investment and (budget) performance review process, authority in the field of information and recommendation in matters of corporate centre expense, instrumental in effecting changes in corporate centre costs, divisional policy, the interpreting of firm-wide plans and projects insofar as they affect corporate centre planning, and executive contact for adjudication of interdepartmental matters, source of studies and analyses of more efficient ways to perform corporate centre functions, enforcement of plans to reduce corporate centre costs. It is important to stress that if the controlling mandate is too narrow, the level of management support for the CCCL is too low, or if the CCCL lacks resources and information, effective control cannot be established. Recognising the corporate centre as a profit centre allows us to estimate the necessary variables to use in the direct methods for the measurement of value creation. Based on regression analysis of peer comparisons, this could be relatively straightforward but would consume quite some resources if done for reporting purposes only. If we would like to measure the value added of the corporate centre as part of the group instead of as a standalone unit, then the typical problem that revenues are lacking appears. We therefore present an indirect way of calculating added shareholder value of the corporate centre. We call this the *Residual Value*-method (ResVal-method) and principally it calculates the generated value by the corporate centre as the difference between the generated value of the divisions and the difference in market value of the group over a period of time. In using the ResVal-method, we should calculate the generated value of the divisions before cost allocation of corporate centre's core and added value roles. The assumption is that divisions benefit from being a member of the group and that the corporate centre is responsible for the synergies: divisions by themselves, left to their own devices, would not strive for interdivisional synergies. Capital market participants, shareholders and group management should take careful consideration when the standalone divisions produce a higher added value than the group value. The study also presents detailed benchmarks for costs levels for the corporate centre in financial conglomerates. In order to maximise insight in and control over costs, cost accounting should be done along the lines of work processes, in which value- and cost drivers are distinguished. Activity-Based Costing and Process Standard Direct Costing are appropriate instruments in this respect. In revenue accounting for the treasury function, Matched Funds Transfer Pricing-method should be used.

As discussed, the corporate centre principally has two types of roles and functions, core and added value; shared services could be part of the corporate centre. Allocations for core functions should be seen as a corporate centre cost charge and are motivated by corporate interests. The allocation performs the motivation and influencing functions. Criteria for the corporate centre cost charge should be fairness, neutrality and benefits received. If this burden falls on the corporate centre, then the charge is against group profit and is not used to influence divisions. This is the easiest method but has the effect that divisions experience the corporate centre to be for free or even perceive the corporate centre to be value destroying. Allocations for added-value functions should be justified by costs incurred. The best criteria for this type of allocation are cause and effect, and benefits received. The allocation performs the result allocation, transaction and motivational functions. If they exist, shared-service costs can be allocated based on the replication of a market place. This is done to justify costs and to compute reimbursement and to make economic decisions for resource allocation. Cause and effect, and benefits received must be the main criteria. In setting prices, it is important that the divisions do not form a captive market. Market prices are the main prices used, but cost-based prices might apply. As services might only be partly available on the market, prices should reflect this part availability. Negotiated prices, containing elements of market based prices and cost based prices are appropriate here.

In the **second** and **third** chapters, we discuss four case studies and compare these with the theoretical findings of the first chapter in part 3. After recent reorganisations, the financial conglomerates in the case studies show a tendency to move from more centralised organisational structures, the *strong form of conglomeration*, towards the *weak form of conglomeration* as regional and intransparent structures are reorganised in divisions focused on product/market combinations and a corporate centre. The main difference between the financial conglomerates lies in the presence or absence of an extra management layer between a major division and the executive board. This move towards the weak form of conglomeration is not complete yet, which results in that financial conglomerates are in between variants. Difficult organisational transformation, paired with motivational issues, results in inefficiencies. Also this may lead to incomplete governance, allowing for adverse consequences. Of the case studies, three out of four use shareholder value as tool for performance measurement. To what extent value-based management, including an institutionalised controlling cycle, is implemented in the case studies, is difficult to observe. The study includes a detailed comparison of the case studies with the ICCC. Although there are differences in reporting lines, the case studies indeed match the ICCC to a large extent. What is striking, is that functions according to ICCC are largely present, implementation of value-based management and operational risk management is unclear, coordination instruments are sometimes mixed and not focused, the moral hazard problem is not solved and transparency is sometimes low, there is no unambiguous choice for a single management style, staffing is lower than the benchmark allows, there is a cost centre orientation and only one financial conglomerate has a value measurement, and cost allocation is performed, but remains difficult to initiate and implement. Although financial conglomerates make serious attempts, it seems difficult to decide on and implement the ICCC unambiguously. This might lead to an ineffective corporate centre. There may be organisational obstacles within the financial conglomerates preventing reaching a dynamic state, oscillating around the ideal corporate centre. These obstacles can include the perception that implementing the ICCC is not needed or possible, conflicts of interest between managers, unawareness of the importance of a well-functioning corporate centre, and a focus on only keeping costs low. A clear implementation of the ICCC would enable an effective and efficient corporate centre reaping the benefits of synergies, which would allow financial conglomerate structures to prove their worth and prove manager's actions right.

ANNEXES

Questionnaire

A Corporate centre mission, strategy & implementation

1 Please describe the mission and strategy of the CC

2 Please describe how the strategy is implemented (i.e. what are detailed action items for CC-management, what are the instruments of coordination used)

3 Which conditions are met so that the corporate centre can add value, how does the corporate centre add value and how is this added value determined/calculated

B Corporate centre management style

4. How would you classify the organisation structure of the financial institution as a whole (e.g. independent profit centres, integrated business units, strong staff groups at corporate centre or at division)

5. How would you classify the role of the corporate centre in divisional business planning and budgeting and why (e.g. how extensive, which focus)

6. In relation to divisional autonomy, how would you classify the leadership performed by the corporate centre and why, and how is any type of (minimum) leadership performed (e.g. sponsoring, reach, dependencies, level of coordination)

7. Which focus do the resource allocation and objective setting have (e.g. short/long term, linkage personal incentives)

8. How would you classify the CC-performance/cost control system and why (e.g. how tight/loose)

C Scope of the corporate centre

9 Which types of activities are distinguished and what are their focus (e.g. management, service, coordination)

10 Which functions do you have in the corporate centre and what are their main activities (e.g. Human Resources, Procurement), please indicate how many fte work in the different sectors in absolute numbers and in % of group total

11 Which group-wide committees do you have and what are their main activities, who is chairing the committees

D Corporate centre performance

12. How are the different CC-departments financially managed (e.g. Treasury and Procurement as profit centres, Controlling as cost centre)

13 How does the planning and budget process for the CC-departments take place

14 How do you know that CC-costs in relation to the CC-services are reasonable (e.g. via manager incentives)

15 What is the format on the calculation of the CC- P/L-account

16 Where is CC-cost supervised (e.g. by which function, multiple answers)

17 What is the authority/mandate of the executive responsible for CC-controlling

18 How does qualitative measurement of CC- departments take place

19 What are the detailed procedures (if any) of allocating CC-costs to divisions

20 How much of the CC-costs (in %) gets charged to divisions

21 What are the reasons to charge CC-costs to divisions

22 Other observations and remarks for expectation of future developments

List of Interviewees

ABN AMRO Bank NV, Amsterdam, the Netherlands

Mr. Tom de Swaan	Chief Financial Officer & Head Corporate Centre	04.01.2001	
Ms. Saskia van Dun	Assistant-to Mr. De Swaan	04.01.2001 16.10.2001	Also email and telephone exchange

Credit Suisse Group AG, Zurich, Switzerland

Mr Peter Bachmann	Head Group Accounting & Reporting	27.09.2000	
Ms. Beatrice Fischer	Corporate Secretary	20.09.2000	
Dr. Stefan Götz	Head Corporate Development	27.09.2000	
Mr. Philip Hess	Head Chief of Staff	23.11.2000	
Mr. Pierre Schreiber	Head Corporate Secretary	20.09.2000	
Mr. Thomas Widmer	Head Group Controlling & Deputy Head Group Accounting & Reporting	03.08.2000 17.08.2000 25.10.2001	Also email and telephone exchange

Deutsche Bank AG, Frankfurt, Germany

Mr. Joachim Hellermann	Head Corporate Centre Coordination	29.05.2000 26.09.2000 11.10.2001	Also telephone conversation
Mr. Yvo Postleb	Assistant-to Mr. Hellermann	29.05.2000	Also email and telephone exchange

UBS AG, Zurich and Basel, Switzerland

Mr. Rolf Enderli	Head Group Treasury	07.02.2000	
Mr. Damian Imboden	Group Strategic Analysis	19.04.2000	
Dr. Peter Pop	Head Corporate Centre Operations	03.10.2000 16.10.2001	Also email and telephone exchange

Value per Share Methodology

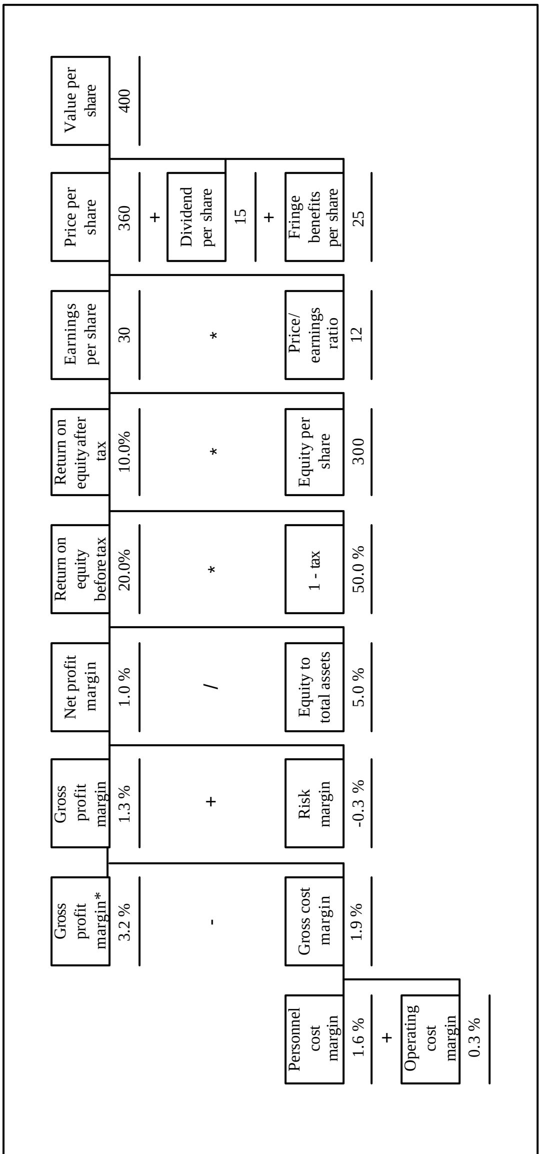


Figure 63: Example of Value per share methodology

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LIST OF ABBREVIATIONS

AA	ABN AMRO Bank NV
ABC	Activity Based Costing
AG	Aktiengesellschaft
ALM	Asset & Liability Management
ß	Company or division specific risk factor
BMD	Group Board of Managing Directors
BU	Business Unit
CCC	Corporate Centre core
CCCL	Corporate Centre Controller
CEO	Chief Executive Officer
c_{eq}	Cost of Equity
CFO	Chief Financial Officer
CFROI	Cash Flow Return on Investment
CHRO	Chief Human Resources Officer
CIO	Chief Information Officer
CMBD	Chairman of the Board of Managing Directors
CoS	Chief of Staff
CRO	Chief Risk Officer
CRO OR	Chief Risk Officer for Operational Risks
CSG	Credit Suisse Group AG
? f	Potential change in underlying factors
DB	Deutsche Bank AG
DF	Divisional functions
EBIT	Earnings Before Interest and Taxes
EC	Economic Capital
e.g.	For example
EMU	European Monetary Union
etc.	Et cetera
EU	European Union
EP	Economic Profit
EVA ™	Economic Value Added
EVP	Executive Vice President
ff	And further
FCF	Free Cash Flow
fte	Full time equivalent
MfV	Managing for Value
GCEO	Group Chief Executive Officer
GCFO	Group Chief Financial Officer

GCRO	Group Chief Risk Officer
GMB	Group Managing Board
GxB	Group Executive Board
IC	Invested Capital
ICCC	Integrated Corporate Centre Concept
MFTP	Matched Funds Transfer Pricing Method
N/A	Not available
NOPAIT	Net Operating Profit after Interest and Tax
NOPAT	Net Operating Profit after Tax
OECD	Organisation for Economic Co-operation and Development
p.	Page
$Pos_{market\ value}$	Market value of positions
PSDC	Process Standard Direct Costing
pp.	Pages
RAROC	Risk-Adjusted Return on Capital
RARORAC	Risk-Adjusted Return on Risk-Adjusted Capital
RoE	Return on Equity
R_f	Riskfree rate
R_m	Average market return
ROIC	Return on Invested Capital
RORAC	Return on Risk-Adjusted Capital
R_p	Equity risk premium
SC	Support centre
SEVP	Senior Executive Vice President
S_f	Sensitivity of positions to changes in underlying factors f
TSR	Total Shareholders Return
UBS	UBS AG
VaR	Value at Risk
VBA	Value-Based Analysis
VBM	Value-Based Management
WACC	Weighted Average Cost of Capital
SBU	Strategic Business Unit
SC	Support centre
SVA	Shareholder Value Added
VpS	Value per Share

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CURRICULUM VITAE

Dr. Eelco R.W. Fiole[1] (Rotterdam, the Netherlands, 1969) studied Mechanical Engineering (B.Sc., 1991) at the Rotterdam University of Applied Sciences, and Business Administration (M.Sc., 1994) at the Rotterdam School of Management, Erasmus University Rotterdam. During his studies he completed various internships with a.o. Akzo Nobel, Dow Chemical and Royal Dutch/Shell. After graduation, he joined ABN AMRO Bank in Amsterdam where he, after a rotational traineeship, joined the Corporate Banking department in Maastricht as an Assistant Vice President. In 1997 he moved to Basel, Switzerland, joining Swiss Bank Corporation as a Financial Analyst and Associate Director in the strategic Corporate Sourcing department. Later that year he was appointed Head of Interdivisional Service Agreements. In 1999, as a Director, he was appointed Head of Corporate Centre Controlling of UBS, the product of the merger between Swiss Bank Corporation and Union Bank of Switzerland, based in Zurich. After having commenced part-time on a doctoral dissertation in Business Economics at the University of Basel in 1998 with Professor Dr. Dr. h. c. Henner Schierenbeck and Professor Dr. Dick M.N. van Wensveen (Erasmus University Rotterdam and University of Amsterdam), he committed himself to this study fulltime in 2000. In 2001, he moved with his wife to Singapore, where the dissertation was completed and where he was active as a freelance finance consultant. Upon receiving his doctoral degree, he joined the bank consulting firm zeb/rolfes.schierenbeck.associates as a Manager in their Zurich-office. During his career, he attended various business courses at a.o. AIF/INSEAD, Stanford Graduate School of Business, Stern School of Business, UBS Warburg, University of St.Gall and the Wharton School.

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