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Global strategies to overcome the spiral of decline in universal bank markets[☆]

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Abstract

Although there has been an increase in the overall financial services market, the profitability of banks world-wide has decreased from the early 1980s to the 1990s. This has been attributed to several factors: the decline of traditional banking activities (deposit taking and lending); poorly performing debts (arising from poor lending decisions); and, for domestic banks, depressed property prices and important local industrial sectors performing badly. However, the analyses of bank performance tend to be short-term and narrow in their outlook, and seldom attempt to explain the underlying trends and processes of change. In this paper it is argued that the broad competitive forces of information technology, globalisation and deregulation are destabilising the banking industry leading to irrevocable changes which allow new entrants, disintermediation, innovation and customer changes on a much greater scale than has occurred in the past. These concepts are illustrated using a range of different bank markets as examples. To compete in these new markets different approaches are needed, and a series of possible strategies for addressing new bank markets are outlined with reference to size and type of bank. The long-term outlook for banking is discussed with particular attention being focussed on the changing role of universal banks. © 1998 Elsevier Science B.V. All rights reserved.

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1. Introduction

Information technology creates new opportunities for the banks in the way they organise product development, delivery and marketing. IT also allows other financial and even non-financial organisations to start offering bank services. Similarly deregulation both within countries and across national boundaries allows increased international competition

[☆] Dedicated to the memory of Professor Geoff Lockett, 1941–1947.

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between banks, financial and non-financial organisations. Bank markets in general, like many other markets, are also becoming more global.

The combination of new IT, deregulation and globalisation pressures ensures that new ideas and innovations spread quickly and break down the traditional barriers to entry in the banking industry. This can be seen clearly in the internationalisation of retail financial services (including banking), particularly across Europe and the USA, by the development of novel banking systems such as Digicash (Holland and Cortese, 1995) and IBOS (Economist Intelligence Unit 1994) and the growth of retailer and automotive company activities in what were once traditional bank markets such as deposits and loans. For example Ford Financial Services generates over a billion dollars in profit for the car maker and dis-intermediates the banks from their traditional role of providing finance for automotive purchases (Kapoor, 1994, 1995).

Overall, these factors have resulted in a decline in universal banking i.e. the provision of most or all financial services under a single, largely unified banking structure (Heffeman, 1996), which has led some commentators to question the long-term viability of retail banks (Anon, 1996). The decrease in the profitability of universal banking was attributed to a number of factors, notably poorly performing loans made to domestic corporate customers by American, UK and French banks and also international loans to less-developed-countries (LDCs), high cost bases, and increased competition. Bad loans are clearly a short-to-medium term crisis which can be overcome if an individual bank has sufficient reserves. Similarly a high cost base can be reduced over time by prudent management and rationalisation after merger. However, the level of competition will continue to grow and take many innovative forms. The focus of this paper is to examine the nature of the new competitive environment for banks, in particular the role of IT in (1) enabling bank markets and competition to become more international; (2) supporting new entrants' strategies; and (3) enabling innovation in banking.

Globalisation and information technology are combining to create a more unstable banking environment in which new entrants and innovation are reducing the traditional income streams of banks. The dynamics of the banking industry are related to the reduction in revenues and it is postulated here that, in general, the universal banking industry is entering a spiral of decline. The strategic responses of most large banks, particularly the trend towards mega-mergers and internal cost-cutting, are shown to be insufficient in the long term to offset the reduction in income and counter the new competitive forces. A range of strategic options are outlined that will allow a minority of individual banks to prosper in the new banking environment and these options will be discussed with reference to different sizes and types of banks. To understand the dynamics of the banking industry, it is necessary to consider the collective impact of globalisation and IT on the strategies and structures of individual banks. Research on the effects of these forces in banking tends to be narrow in its focus, for example analysing one market segment (Large 1996, cross-border payments), a specific type of technology (Tomasula 1996, relational databases) or a limited geographic market (Javetski 1996, French banks). This is true both for academic research papers and for many market research projects carried out by the banks. The purpose of this paper is to give an overview of the diverse range of phenomena occurring in the banking industry and explain them in theoretical terms. The research is of importance for gaining a general understanding of the banking industry and also for providing

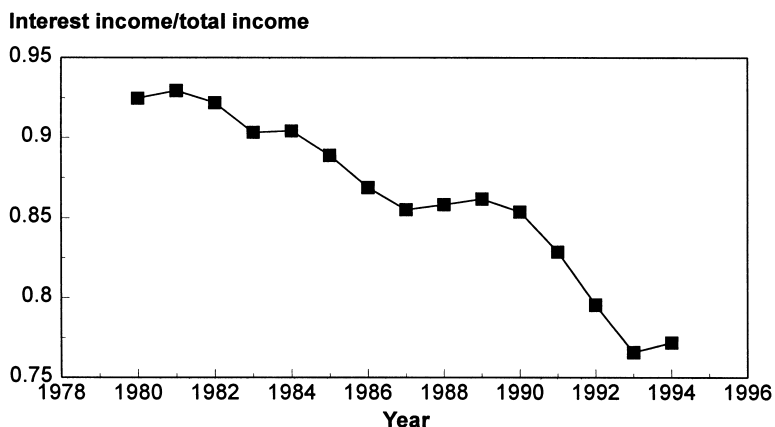


Fig. 1. The decline of traditional banking activity in the USA (source: US Federal Deposit Insurance Corporation statistics on banking).

insights into the development of individual bank strategy. In the next section an overview of universal bank markets is presented.

2. Universal bank markets

The competitive forces in banking have led to a decline in universal banking indicated by a reduction in the profitability of banks (Gorton and Rosen, 1995; Edwards and Mishkin, 1995; Danton, 1992; Colwell, 1991). Until the 1980s bank markets were relatively stable and bank profits were high. In the early 1970s the net interest spread between lending and deposit taking accounted for a large percentage of total income (around 80%) for the four large universal banks in the UK: Barclays, NatWest, Lloyds and Midland. By 1990 the figure was approximately 60% (Colwell, 1991). (The balance of the bank's incomes would be completed by fee based income.) This picture is also true for American banks over the same period; Fig. 1 illustrates how interest income as a proportion of total income has declined since 1980 in the USA.

For a corporate bank, the ratio of fees to lending would be greater than for a universal bank but lending income would still provide the bulk of the earnings. In a stable environment it was possible for banks to secure low risk, high returns on their capital. Losses only occurred as a result of poor risk management or failed own account trading. However, significant changes in the competitive forces are destabilising the status quo in banking, as will now be discussed. (For a broader discussion of the relationships between shrinking bank markets, bank strategy and risk see The Economist, 1996a.)

3. Competitive forces

The three major forces of deregulation, globalisation and information technology affect each other and it is their *collective* as well as individual impact on banks that is of interest.

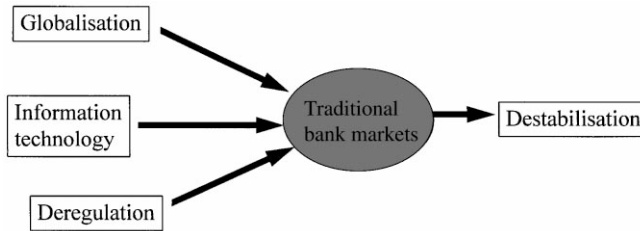


Fig. 2. Competitive forces in banking.

Their combined effect is to destabilise traditional bank markets and to create a new environment for banks in which to compete (see Fig. 2).

Deregulation in the USA banking industry creates new opportunities for regional banks to compete in other states (Harrington and Warf, 1995), and information technology makes strategic innovations possible. For example, IT and novel marketing strategies create opportunities to deliver financial services through alliances which allow the shared use of technology platforms such as Automatic Teller Machines (ATMs) and payment processing systems. Another example is the global management of international relationships (Javetski et al., 1995; Dwyer, 1995). Bank customers are creating new organisation structures which are managed on a global scale and co-ordinated through networked information systems. These structures often involve multiple decision-makers located in different continents, and complex inter-dependencies exist which require access to financial expertise across product ranges and geographic boundaries (Javetski et al., 1995). It no longer makes sense for a bank to treat these types of customers as national entities. What is needed is an approach that can accommodate the varied demands of the customer by offering bank products, knowledge and expertise, and relationship management on a global scale. The only effective way to co-ordinate this type of activity quickly is through electronic delivery channels.

The number of new entrants into banking markets is rapidly increasing, for example international banks offering domestic services, financial organisations diversifying into banking, and non-financial organisations such as retailers providing banking products. With increased globalisation of competition, foreign banks can enter domestic markets and focus on niche markets. They can ‘cherry pick’ the most profitable customers by assessing their risk and banking requirements more accurately than a more general marketing offering by the domestic banks. This can, of course, work in both directions but to make the strategy successful a bank must have some form of competitive advantage, normally arising from superior information systems and marketing.

At an aggregate level what has made the competitive forces of deregulation, globalisation and information technology so powerful in the 1980s and 1990s is the extent of the changes: deregulation of financial markets on a global scale; the emergence of truly global trading systems composed of networks of individual organisations; and the creation of extremely cheap and effective telecommunications networks for both retail and industrial customers, which make the international flow of trade and bank data an almost trivial

exercise. Individual instances of change are continuously announced and analysed in the business press (e.g. see Crane and Bodie, 1996).

4. Illustrative examples

In this section a group of products and services is presented to demonstrate the impact of deregulation, globalisation and IT on different bank markets. The examples cover a broad range of markets, customers, banking arrangements and IT solutions and show both the fragmentation and consolidation that is now possible. The sample of cases was chosen to illustrate many types of innovation that were being undertaken in the provision of banking services.

4.1. International wholesale payments market

International payments has traditionally been carried out through the Society for Worldwide Interbank Financial Telecommunication (SWIFT) network which was established in 1973 (European Monetary Institute, 1996). Banking regulations ensure that the SWIFT club of international banks which form the world-wide network of correspondent banks receive income for managing payment transactions and also from interest earned while the money is in their temporary control. On a global basis, the scale of international, or cross-border, payments is estimated to be 250 million transactions in 1994 growing to 750 million transactions by 2004, with monetary values of US\$109 trillion and £309 trillion respectively (Boston Consulting Group, 1996). The administrative control by SWIFT of the international payments market remained broadly static from the inception of the SWIFT network to the early 1990s when a range of alternative mechanisms for managing international funds transfer emerged. The new entrants include IBOS (Holland et al., 1996), centralised treasury management by corporate organisations (Holland et al., 1994), and the low price, value-added services offered by global banks such as ABN Amro and Citibank (Boston Consulting Group, 1996) and smart card technology (Holland and Cortese, 1995). The effect of these new entrants is to reduce the overall size of the payments market by offering cheaper and in most cases faster methods of moving money. The combined effect of the new entrants and innovation is to make the revenues grow much slower than the payment volumes. Boston Consulting Group (1996) estimate that revenues generated from this market will grow from US\$16 billion in 1994 to US\$24 billion in 2004 compared with a threefold increase in payment volumes over the same period. The reduction in unit prices will have a significant impact at an aggregate level, particularly on the incumbent systems such as SWIFT. It appears likely that there will only be a small number of truly global banks capable of processing large volumes of payments efficiently and that if these banks are able to increase their value-added services then the SWIFT network will continue to decline in importance.

4.2. Retail banking

In retail banking the traditional relationship has been between the bank's staff and individual customers. The bank's principal role was to act as an intermediary between

the customer and the financial markets, typically using its own products. With the advent of electronic delivery channels and the deregulation of the financial services market in many countries, it is possible for new entrants to offer banking and other financial services direct to the end customer. Technology such as database marketing, risk management software and electronic delivery channels such as the telephone, satellite communications, the Internet or a combination of all of these, allows new entrants quickly and easily to enter the banking market and select the most profitable customers.

A good example of a foreign bank entering a domestic market and picking the most profitable customers for a particular product-market is MBNA Corporation (Weber, 1994). MBNA markets credit cards using affinity programs. It contacts organisations whose members are likely to fit the profile of profitable bank customers and develops a joint marketing strategy where the profits from the transactions are divided between MBNA and the affinity organisation. To implement this type of business marketing strategy successfully, flexible information systems are needed to manage the large number of individual consumers and their relationships to particular organisations.

Another example of innovation within the banking industry is the case of First Direct, a telephone-based direct banking operation which is owned by an incumbent, Midland Bank. First Direct successfully launched an innovative banking product using simple technology to offer superior customer service. The effects are to create a new banking unit with lower cost/income ratios but to add to the total cost of infrastructure for the parent bank. Similar initiatives are taking place in other financial services such as insurance, for example the case of Direct Line Insurance PLC (Channon, 1996).

The dis-intermediation of the traditional banking structures has several effects: it lowers profit margins for the banking/insurance industry as a whole; it makes economies of scale more difficult to realise for financial institutions with expensive legacy systems; and it raises the expectations of the customer markets because in many cases superior products are being offered at lower prices.

4.3. Securitization of assets

Companies with a secure cash flow from their customers, for example utility companies and large retailing organisations, are now able to treat the cash flows as an asset and create securities whose value is based on the volume and reliability of the cash flows. The securities can then be sold privately to institutional investors or sold publicly. This system is advantageous to the issuing companies when the cost of raising funds in this way is less than the cost using other methods, notably short-term borrowing from financial institutions such as banks. Securitization of assets has the effect of dis-intermediating the banks from their traditional role of taking deposits and lending. The combination of deregulation and information technology are making capital markets easier to access for both the issuers (normally the company owning the underlying assets such as a large group of customers) and the investors. This type of activity is likely to grow and erode market share of lending from the banks.

An example of how this concept has been applied is in the retail pharmaceutical industry (Schifrin, 1996). Retail pharmacists in the USA manage high volumes of low-value transactions, and US\$40bn worth of the prescriptions market is paid for through health

care plans where the payment is guaranteed by the customer's health care organisation. The risk element in these transaction is 3% which results in over US\$1bn underpayment. Ordinarily the pharmacists would fund their operations through bank loans but a company has been set up to securitize the payments assets and sell them to investors. Advanced payment information systems, which connect the pharmacists to the special company set up to market the assets, aim to reduce the risk of non-payment by credit checking, and manage funding to the pharmacists and payment to the investors. The whole process takes the traditional bank out of the cash supply chain.

4.4. Virtual banking

One notion of virtual banking is the replacement of traditional delivery channels for bank products, particularly bank branches, by electronic channels such as telephone, cable and satellite TV, the Internet or a combination of these channels. These developments are being rapidly implemented and are extremely important, but they represent only one facet of the virtualisation process underway in banking at the customer interface. In addition to these changes there are significant alterations taking place in the networks of relationships between banks and their information services suppliers, which represent new forms of virtual organisations based on the sharing of assets, information and marketing co-operation through webs of relationships. For example, Barclays virtual global bank offers small and medium sized national banks an alternative to expensive multiple correspondent relationships to gain an international presence for payments and receivables (Lockett and Holland, 1996). Barclays provides an electronic link between its own global market network and national banks which allows the national banks to reduce their international correspondent network with the possibility of using Barclays as a single supplier of international payments and foreign exchange. This is particularly attractive to those banks whose revenue from reciprocal banking arrangements is smaller than the cost of maintaining banking relationships measured by IT spend, administration costs and cash float interest losses.

4.5. Digital cash

Two major objectives of the banking system are to provide liquidity for trade and security for the exchange of money. As more trade is conducted electronically, the short-falls of traditional methods of financial exchange through the existing banking systems become apparent. The high cost of international payments made it particularly difficult to make one-off, small value deals viable. However, there are now a number of different digital cash alternatives which can be exchanged between any individuals or companies world-wide through some form of electronic channel, whether this is the telephone system or the Internet. The competing digital alternatives to cash include bank offerings such as NatWest's Mondex card and Citibank's monetary systems, and non-bank products from new entrants such as Digicash and Cybercash (Holland and Cortese, 1995). Taking deposits and lending are at the heart of a universal bank's activities. If digital cash takes over a significant part of the money supply then the effect on banks will be potentially to reduce their role as a conduit for financial transactions which could then have knock-on effects for lending and deposit taking. At the moment banks generally have a good reputation with

consumers but if a reputable organisation from another industry were to offer a viable digital alternative to cash then it could reduce the importance of banks.

4.6. *Just-in-time (JIT) finance*

Commercial organisations require liquidity for trading and need to be able to move money between divisions within the same company and between themselves and their customers and suppliers. An important role for banks is to provide the liquidity necessary for their customers' trading activities. If a company trades internationally, added complexities are international funds transfer and foreign exchange. Traditionally, companies would have tended to have multiple bank relationships within each country of operation. The following examples suggest that the demand for short-term cash borrowings from banks will diminish as JIT finance becomes more common.

In manufacturing industry the concept of JIT delivery of physical products is well established and the benefits proven (Browne et al., 1993). The major cited benefits from implementing JIT techniques in manufacturing are improved performance in asset management, lead-times and back-orders. Quality is also improved because problems in business processes become more transparent and can be resolved much more quickly than when they were hidden by large reserves of stock and work-in-progress. It seems reasonable that if JIT techniques can be applied to the management of the flow of physical products through a supply chain then they should also be applicable in a financial context. The dearth of case examples in finance is because banking lags behind manufacturing industry in its investment in information technology and concomitant innovation in business practice. However some recent examples do demonstrate how JIT finance is beginning to affect banking.

Rabobank is developing a JIT finance system for its customers with the objective of delivering credit finance on a JIT basis. That is, advance payments will be made by the bank to an organisation for deliveries and transactions which have actually taken place between the organisation and its customers (Kerkhof, 1996). Credit to support the development of the business is delivered in frequent small quantities to match the actual logistics processes. The EDI co-ordinator of the bank believes that this method of financing will result in better risk management which can be passed onto the bank's customers through lower interest rates and lower levels of outstanding debt because the debt is only increased as it is actually needed, rather than taking large amounts of credit infrequently. This is an interesting example because it demonstrates the viability of new methods of financing businesses based on inter-organisational use of information systems connecting the bank with customers and suppliers within a supply chain. However, it may understate the true potential of JIT money. Motorola and Citibank have developed a global system for managing the internal treasury function of Motorola and payments with its suppliers (Holland et al., 1994). The objective here is not for the suppliers of Motorola to receive finance from the bank on a JIT basis, but to receive payments from Motorola so that cash flows mirror product flows. Citibank's principal role is to deliver the payment rather than provide JIT finance. It can be seen that if all companies started to pay their suppliers as soon as they received the product then manufacturing supply chains would require much less financial liquidity, in exactly the same way that stock levels are reduced when JIT

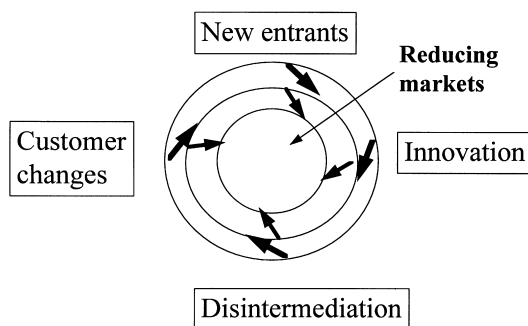


Fig. 3. Spiral of decline model.

manufacturing techniques are used. The effect on banks will be to reduce the level of funding needed to support the working capital cycle of customers because the uncertainty of their cash flows will be reduced considerably. (There will also be significant effects on accounting because credit management will be made much simpler.)

5. Case discussion and proposed model

In addition to these examples of market change, there are many others which are affecting bank profitability, for example smaller margins in the foreign exchange market (Harveson, 1996) and reductions in the size of profitability of lending and deposit markets (The Economist, 1996a). The basic argument is that traditional banking strategies and structures based on high investments in building and legacy computer systems are being undermined by a combination of innovation within the banking industry and the entry of new banking products from outside the industry.

The principal outcomes of these developments are grouped under four categories of change that are affecting banks. The categories are intended to capture the major changes and distinguish them by differences in competitive strategies. The categories are based on Porter's five forces model (Porter, 1980). They are: (1) new entrants from outside the banking industry; (2) innovation from existing banks which represent a step-change in business practice; (3) dis-intermediation; and (4) customer changes. The combination of these forces leads to a spiral of decline in the traditional bank markets which is shown in Fig. 3.

In all the case examples of different markets cited here, a combination of the forces in the spiral of decline model has changed fundamentally the size and organisation of the market. In the case of international payments, the new entrants include IBOS, smart cards, Digicash and company-based cash management systems designed to reduce the volumes of payments to the banks by off-setting cash flows within a group of companies (Holland et al., 1994; Holland and Cortese, 1995). The effect of these new entrants is to reduce the overall size of the payments market by offering cheaper and in most cases faster methods of moving money. Similarly, in the retail banking example, the traditional relationship has been between the bank's staff and individual customers. The bank, typically using its own

products, acted as an intermediary between the customer and the financial markets. Electronic delivery channels and the deregulation of the financial services market in many countries have made it possible for new entrants to offer banking and other financial services direct to the end customer. These new entrants can quickly and easily enter the banking market and select the most profitable customers by using technology such as marketing, risk management software and electronic delivery channels. This dis-intermediation of the traditional banking structures has several effects: it lowers profit margins, it makes economies of scale more difficult to realise for banks with expensive legacy systems, and it raises the expectations of the banking market as a whole because superior products are being offered in many cases. Another form of dis-intermediation is shown in the case of securitization of assets where banks are taken out of the traditional money supply chain. Virtual banking is an example of an innovation from existing banks which provides a step change in banking practice. It improves the throughput of the processes of one of the partners, and allows regional banks to offer an international service to its customers. In the case of digital cash the innovation is both from within and beyond the banking industry. It may encompass all the categories of change including that of customers. The final cases of JIT finance are clear illustrations of customer changes. In these instances the dominant forces are the customers who are applying the same management approaches to money as they have successfully done to logistics. All of the cases show to varying extents how the combination of new entrants into traditional bank markets, customer changes, innovation in products and processes, and large-scale dis-intermediation of universal banks is leading to a decline in profitability and the reduction of universal bank markets.

The prediction from the spiral of decline model is that income streams for a universal bank are gradually declining because of new entrants, customer changes, disintermediation and innovation. If declining revenues are combined with economic cycles one would expect a cyclical downward curve of revenues and profitability. Although the cost-cutting of the banks improves the profit level, it is postulated that simple cost-cutting or economies of scale from shared operations arising from mergers will be insufficient to counter the long term loss of revenues. In some instances universal banks were innovative but in general their organisations and culture encourage inertia, and it is unlikely that they can be the principal agents of change. The situation can be compared to that of the computer mainframe manufactures a decade ago, which resulted in the major developments occurring beyond their organisational boundaries.

6. The strategic response of banks

The main strategic response of universal banks with expensive building and system infrastructures has been to cut costs using a variety of methods. The most obvious change to the banking industry is the spate of mergers and acquisitions (The Economist, 1996b), where economies of scale arising from shared technology and a larger customer base are cited. However, significantly better customer service is rarely mentioned. Although cost cutting serves the purpose of maintaining profits in the short run it does not address the more fundamental issues of poor customer service, slow product innovation and falling or

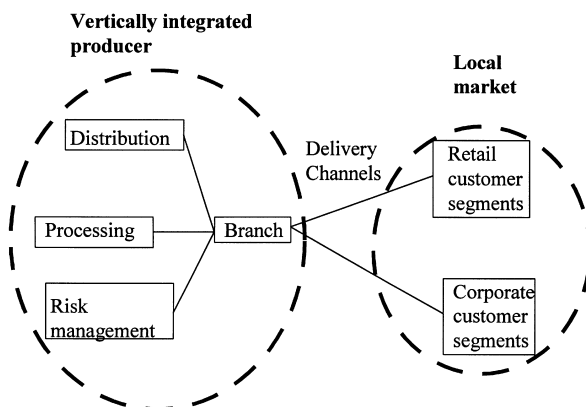


Fig. 4. The historical value chain for a universal bank.

static revenues. It has also led to internecine debates about cost allocation of central systems to individual product groups and new product investment. This is particularly noticeable in banks that have launched innovative products, such as telephone banking, which compete directly with established products. An internal focus on cost-cutting and management de-layering inevitably affects the ability of a bank to understand its customers' needs and may mask the spiral of decline. The increased sophistication and willingness of customers to switch banks exacerbates the situation. A different approach to market strategy for existing universal banks is to focus on a particular stage of the value chain as outlined in the next section.

7. Focus strategies

The universal bank's markets are still determined by the historic influence of providing a wide range of services to a broad localised target market. The key reason for attempting to capture as large a share as possible of a local market was to cover the fixed cost of operating a branch which until recently completed most of the value added functions for the customer (sales, processing and localised decision making/risk taking). In their own local markets banks typically have a high share of the existing business (see Fig. 4).

A number of institutions are attempting to sustain the cost savings of removing the individual processes from the branches and increasing the scale efficiencies of the centralised processes by merging with similar types of organisation. This may improve the position in the short term but in essence it is using the merger as a defence mechanism against the other market pressures discussed in this paper. However, those institutions that proactively use the development in technology to change positively the way that they produce and deliver services to meet the developing needs of specific market segments have a strong potential to increase their market share. Examples of this approach include the following:

1. Rather than attempt to replicate their existing vertically integrated business in new

markets, the universal banks can focus on developing their total global market share of a specific portion of the value chain.

2. The processing and risk-taking capabilities of separate financial institutions can be integrated to produce an electronically delivered packaged product that looks as though it is has been produced by the institution managing the client relationship (the distributor).
3. The ability to integrate processes offered by separate financial institutions has greatly reduced the entry costs to markets by enabling the new entrant to purchase the components of its financial products on a variable basis rather than building the whole infrastructure.

These concepts are developed into generic universal banking strategies which are already discernible in the leading financial institutions and are discussed more fully below.

7.1. Processing business

Once a financial institution has invested in automating a particular internal process it has the potential to offer the capability to other institutions that have yet to make the investment. By centrally processing transactions for a number of institutions the unit cost can be reduced to each of the players. The universal bank providing the service increases its income to fund further developments and further specialise in the production of a specific process. While this is common practice in credit card and payment processing within the USA, there is the potential for a world-wide market to develop with the concentration of core processing sites from thousands of internal providers to three or four global producers.

Before investing in automating an individual process large universal banks should determine if they believe they can develop the capability into a service that can serve a global customer base. If they cannot then efforts should be made to develop an alliance with an institution that has already made a large portion of the investment and that is looking to build scale economies. By passing the processing capability to another institution the benefits of automation should be delivered earlier, access provided to a higher level of investment in developing the service, and capital that would have been used to build the capability is freed up to invest in an area in which the bank has a real strength.

7.2. Global risk management

The cost of operating a trading operation in a specific market has been increasing steadily with the growing sophistication of real-time market information and decision-making tools used to compete in the markets. The increasing transparency of financial markets and the ability to link directly to market makers have created the opportunity for institutions automatically to pass specific elements of risk to the capital and money markets at a transparent cost without operating their own dealing system.

The risk takers with the ability to provide automated links to their customers can serve a global customer base of financial institutions in a timely fashion without facing capacity restraints. The institutions that are willing to link to specialist risk takers eliminate the

requirement to maintain expensive dealing operations and again free up capital to invest in areas where they believe they have a strength.

7.3. Global brand

There are several thousand brand names in the global financial industry with relatively little differentiation to separate their product offerings. Surprisingly few financial institutions approach the marketing expenditure of the leading global brands in other industries (e.g. Coca Cola, Toyota). By focusing on the needs of specific markets and reducing the cost of serving the customer base by integrating with specialist risk-takers and processors, institutions can raise the marketing expenditure to create a global brand. The ability to directly access customers electronically reduces the barriers to new markets, and the ability to link electronically to existing institutions serving a market provides the opportunity to sell branded financial products through established distribution channels.

8. Summary of focus strategies

Universal banks serving a large portion of a local market need to determine which particular parts of the value chain have the potential to be developed into globally competitive businesses in their own right. By working in partnership with other institutions to reduce the number of elements that require investment, and by focusing on areas of strength, the universal banks can continue to improve the capabilities and services provided to their current customer base while reducing the actual cost of supporting the services.

The banks that continue to operate a vertically integrated structure focused on cutting the costs of each specific process by merging with similar organisations or improved process control are in danger of being unable to respond to the improvement in the financial services offered by institutions focused on specific global market segments. Once the market recognises significant differences in the quality and price of the financial services offered the customers' historic reluctance to move suppliers could be overcome. If the existing universal banks leave their response until the time they recognise a reduction in market share they are unlikely to be able to react sufficiently quickly to recoup their position.

9. Conclusions

The combined forces of deregulation, globalisation and information technology have already changed the performances, strategies and structures of individual banks, as witnessed by declining profitability (Colwell, 1991; Danton, 1992; Gorton and Rosen, 1995), the spate of mergers in the late 1980s and early 1990s (The Economist, 1996b), and the development of innovative products that exploit electronic delivery channels. The important point about the impact of IT particularly is that manufacturing industry underwent similarly dramatic changes approximately 10 years earlier than the banks. The future

pace of change and scale of restructuring in the banking industry is therefore likely to increase until at least the year 2005.

The principal argument in this paper is that the bank environment is destabilised by the competitive forces of globalisation, deregulation and information technology. This leads to significant and important changes in almost every bank product-market: new entrants, dis-intermediation, customer changes and innovation. The inevitable result of these forces is a shrinkage in the size of the universal bank markets and, assuming that banks retain similar cost structures, a decline in their profitability. The changes to bank competition and concomitant reduction in the size of bank markets is encapsulated in the spiral of decline model. The main strategic response of the banking industry so far has been varied but several patterns emerge: cost-cutting, mega-mergers, increased risk-taking for both traditional and fee based income, and automation.

Significant cost-cutting strategies are exemplified by the retail banks, particularly in the UK, but also in other European countries. Such strategies are an attempt to align the cost structures of incumbent banks with those of new entrants such as direct banking operations and, in the UK, building societies. However, it is questionable whether making the existing systems more efficient is a viable response in the long-term as new entrants and banking innovations continue to develop, further eroding the income streams of traditional banks. The mega-mergers of Chase Manhattan and Chemical, Mitsubishi and Bank of Tokyo, and Wells Fargo and First Interstate, represent a size strategy. That is, in response to external pressures, these banks have growth through mergers and/or acquisitions on the basis that the biggest banks will perform best in the new environment. Apart from achieving economies of scale, breadth and depth of product expertise on a global scale are often given as the logic for these mergers (The Economist, 1996b; Waters, 1995). Implicit assumptions in the mega-merger strategy are that: (1) size is important in bank marketing; and (2) the improvements achieved in the economies of scale will be greater than the cost of merging. These assumptions may be true, but in other industries, particularly manufacturing, there has been a move away from vertically integrated organisations, which the universal bank represents, and more attention has focused on the importance of strategic networks of companies (see Nohria and Eccles, 1992; Konsynski, 1993; Wells, 1996 and Lorenzoni, 1996 for a broader discussion of the theoretical and strategic importance of market networks). The focus strategies outlined earlier are examples of replacing the vertical integrated universal bank with a value-chain composed of a network of different banks' processes. The analogy with manufacturing should not be taken too far because the handling of electronic information is a far simpler and quicker process than that of production of a complicated physical product. Technically, the component parts of traditional bank offering can be assembled quickly and easily and distributed to a global market.

The increased risk-taking by banks in an attempt to overcome declining markets has resulted in higher profits for some individual banks, but at an aggregate level, there has been an increase in the number of bank failures and total risk (Gorton and Rosen, 1995; Edwards and Mishkin, 1995; The Economist, 1996a). The growth in automation improves the performance of existing bank operations but it is unlikely that gradual improvements of legacy software systems are sufficient to counter the threat of new entrants and dis-intermediation. New entrants into traditional banking markets are an extremely important

phenomenon. This claim is easily supported when one considers the size, brand name, and global expertise in marketing of the new entrants: automotive, telecommunications and software companies. As more trade takes place electronically, the pressure on the banking system to provide real-time financial support to commercial activities will increase. Innovations such as digital cash, direct access from companies and individuals to capital markets and JIT finance based on real-time transactions will become more attractive. The exponential decrease in the cost of technology and changes to the banking environment mean that the legacy systems and experience of traditional banks may not be as important as the information technology and marketing skills of new entrants.

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