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COMPETITIVE EFFECTS OF IT INNOVATION ON BANK STRATEGY*

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ABSTRACT

Through case study research this paper illustrates opportunities presented by IT-based technological change in British retail bank markets (1985-1995). For the managers of the Royal Bank of Scotland IT appeared to lower entry barriers, exit barriers and deliver high sustainability of competitive advantage. The strategic intent behind diversification patterns of the Royal Bank of Scotland suggested competitive considerations were at a premium because unsolicited take-over bids in the early 1980s put pressure on managers to create growth opportunities. Direct Line Insurance was a subsidiary from the Royal Bank of Scotland. Direct Line was also the first retail finance institution to establish a clear competitive advantage based on information technology. The success of Direct Line enabled an increase in the market share of British retail financial services of The Royal Bank of Scotland. Direct Line is a case of planned success that questions the extent to which banks' competencies must change to master alternative delivery channels. The success of Direct Line also suggested more effective execution than other activities explored by managers of the Royal Bank of Scotland.

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INTRODUCTION

Direct Line Insurance was the first retail finance institution to establish a clear competitive advantage based on information technology (IT). From no established base Direct Line grew to be the biggest direct motor insurer ever in the UK (DL, 1995b). Moreover, the success of Direct Line enabled an increase in the market share of British retail financial services of The Royal Bank of Scotland. Elements of Direct Line's performance depict how companies assimilated the use of information systems over time and highlight the dynamics of how:

> "Actions designed to exploit certain elements of the [market's] structure will, in the process, transform the structure." (Geroski, 1991:158).

Direct Line is a case of planned success which questions the extent to which banks' competencies must change to master alternative delivery channels. Success emerged from a visionary strategy that redefined barriers to enter bank markets and in particular, the distribution of retail insurance products. Direct Line built success around selling motor insurance directly over the telephone to selected market segments. In the process, Direct Line was able to profit from fee income (i.e. premium of insurance underwriting) and a flat and flexible organisational structure.

The discussion is structured as follows. Section 2 presents a brief description of the history and characteristics of telephone-based retail financial services. Section 3 illustrates a brief history of the Royal Bank of Scotland (RBS) and how it addressed technological change. Also discussed is the context in which the bank explored opportunities in bankassurance through a phone-driven subsidiary. Section 4 presents the history of Direct Line Insurance. Section 5 discusses the origins of Direct Line's success. In section 6 the discussion summarises how technical change (i.e. telephone-based operations) modified growth opportunities in bank markets and how technical change altered the stability of the environment, increased competitive pressures and questioned whether bank managers had control of core capabilities.

INFORMATION TECHNOLOGY AND BANKING

The Importance of Non-branch-based Delivery Systems

The most important consequence of the drive towards mass delivery of retail financial services has been that banks effectively moved from decentralised personal relationships to institutional managers[1]. Starting in the late 1970s, banks began to create relationship databases instead of using skilled personnel at all points of contact with customers (BBC, 30-IX-1995). For example, Lesley Taylor (Head of Direct Banking, Royal Bank of Scotland) claimed that current technology allowed one person to develop in 3 or 4 weeks the skills that previously required 5 years in the job (BBC, 30-IX-95. See further Morris, 1986:97). IT applications, therefore, promised higher organisational flexibility to those banks that could effectively implement technical changes.

The second result of technical innovations that redefined banks' business approach related to distribution capabilities. The branch network reduced its importance as the point-of-sale for financial services. New distribution channels were created such as electronic point of sale terminals (EFTPOS), telephone transfer systems and smart cards. However, not all substitutes of the bank branch enjoyed the same success. For example, growth of the most sophisticated gadgets was hampered by conflicts between retailers and banks as to the inadequacy of cash and cheques. Also, as to who should receive the "lion's share" of the profit. As a result by the end of the 1980s, EFTPOS had not turned into a major new source of profit for banks' fee income (Wood, 1989:3; and Channon, 1988:317).

Nevertheless, new distribution channels allowed banks to supply more services and this had dramatic effects in banks' cost structures. For example, Bauer (1995:94) claims that by emphasising IT systems Citibank (New York) was able to serve 85% of its customers by telephone and electronically. For Citibank, automation represented lowering the overall cost rate from 70% to 55% with announced reductions of 30% in branch staff costs (idem p.95). Changing from more to less expensive distribution channels was possible because the same information or transaction could be delivered in a number of ways. However, cheaper processes were an insufficient condition for reduced cost structures. For instance, providing an account's balance costs less

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[1]With the effect that “The banker as a man of stature had been lost.” (Senior Executive. Lloyds Bank Group, 3-III-1995).

through an ATM than at the teller. But only if the total volume of requested balances remains unchanged will the total cost of ATM-supplied balances be less than that provided through branches. Technology, therefore, opened the way for banks to improve their cost structures provided customers changed their behaviour according to banks' expectations.

Telephone-Based Delivery of Retail Financial Services

Perhaps the most successful new delivery channels for financial services were telephone banking operations. Telephone banking evolved to complement ATM networks and physical branches and thus, created a multi-channel distribution system for banks based on an integrated customer account and information system (Gardener, 1995:4).

Distributing retail financial services through the telephone was unsuccessfully pioneered in 1979 by Banc One Corp. of Ohio, USA (Myers-Kanter, 1989:3). Despite Bank One's experience, phone-banking pilot schemes continued and by 1982 telephone transfer systems were operational in a small number of Californian banks (Channon, 1986:387). In 1984, Sanwa Bank (Japan) received 40% of deposits and performed 70% of card transactions through full on-line banking services (idem, p. 312). At that time, Sanwa was also developing push-button phone interfaces (op.cit.).

In 1986, The Bank of Scotland and Nottingham Building Society jointly introduced the first major telephone banking system in Britain (Hughes, 1994:36). The system (called HOBS) aimed at home and office banking. HOBS was swiftly followed by TSB's Speedlink system in 1987. A more advanced version of these systems was developed in October 1989, when Midland Bank established a 24-hour telephone service under the separate identity of First Direct. This was the first British telephone-based, branch-less retail bank.

Since 1989, the proportion of transactions over the phone has growth to a considerable share of total transactions. In the US, transactions represented 24% of total transactions in 1995 (Financial Times, 3-V-95). Customers in European countries prefer other means of distribution to engage in retail finance services as in 1995 telephone-based transactions represented 4% of total transaction sin the UK, 3% in Sweden, 2% in Germany and 1.5% in France (idem).

In spite of international differences to embrace IT applications, the success of new distribution channels consistently undermined an important barrier to entry into banking, that is, the branch network. Banks realised that the innovation presented a threat because branches were no longer required for either processing (as it moved to regional processing centres) or customer contact. The result of technical innovation was that the same branch had potentially become a sunk cost. Technological innovation forced bank managers to face the fact that a vast branch web was a disadvantage for the future and rationalisation was necessary. The challenge for bank managers was startling because in the UK the last rationalisation process began with the amalgamations of the 1870s. Since then, British banks consistently increased the number of home and overseas outlets. However, 9% of UK branches disappeared between 1968 and 1980 (Morris, 1986:85), and approximately 2,000 or 13% of the total were shut between 1987 and 1992 (Morgan et al., 1995:93). In brief, the fact that access to a branch network ceased to be a entry barrier into retail banking meant that telephone-based operations (with its low cost structure) could source a financial competitive advantage to new entrants.

Analysis Framework for Telephone Banking Applications

Table 1 illustrates four types of interactions to describe the way in which retail banks and customers can interact over the telephone. According to Baldock (1994) most banks in the UK adopted the first way of interaction (person to person) or created two separate banking operations (person to person and computer to person). The type of application adopted was based on how managers wished to grapple with two important characteristics of telephone-based services. First, services offered in the person-to-computer system were mainly high volume, standardised and relatively costly through the decentralised traditional platform (transactions such as balance inquiries, transfer between current account and investments, etc.) Secondly, those services that required more sophisticated responses and/or complete information were placed in the person-to-person system.

Table 1: Types of Interaction in Telephone-Based Retail Finance

Customer Interface	*Bank Interface* Person	 Computer
Person	The user speaks directly to the bank representative.	The user interacts with a voice recognition unit or uses a tone pad.
Computer	Computer managed access to required service specialist.	A computer or smart phone interacts directly with the bank's computer system.

Source: Baldock (1994), Channon (1996), author.

The underlying assumption of the person to person and computer to person approach to telephone banking seemed to be that the human being remained the best machine to handle scripted queries. Using persons as final interface also allowed keeping the system's growth opportunities (i.e. architecture) open while the number of options for interaction was computer managed. Under this strategy advisers take customers through a guided conversation (put on the screen by the bank's system) and, in doing so, advisers retrieve all the information the bank actually needs to complete the customers' request through on-screen forms. Advisers don't need to know why certain data is vital, only that they need to follow screen driven protocol (Lesley Taylor, in BBC, 30-IX-95). The system's growth opportunities remain open because system administrators can modify the interaction at will and without the need of major expenditures to retain or retrain the workforce.

In summary, IT applications and especially telephone banking offered possibilities to banks to achieve high organisational flexibility and cost efficiency. Since banks did not control the technology, telephone banking also opened the possibility for new entrants to contest bank markets while, at the same time, banks' "traditional" distribution channel became a sunk cost. The discussion that follows presents these arguments in greater detail by illustrating how a UK bank diversified across product markets and entered retail insurance markets through a telephone-based subsidiary.

THE ROYAL BANK OF SCOTLAND

Origins and Growth

When the Scottish colony of Darien, Panama failed in 1699, many lives were lost and one-quarter of Scotland's liquid assets were lost[2]. Scottish resentment was directed against England since the latter had withdrawn its support and in 1707, when the Scottish and English Parliaments were joined, England agreed to pay Scotland a pecuniary "Equivalent" in compensation for Darien and other losses and debts. Only a fraction of the sum could be paid in cash and debentures were issued. The holders of these became members of the Equivalent Company, to which a banking charter was awarded in 1727. Under the name of The Royal Bank of Scotland a second charter was secured in 1738. Besides allowing an increase in capital, the charter guaranteed the bank's life after the debentures were redeemed.

Initially, The Royal Bank of Scotland did not establish any branches at all but developed correspondent relationships. This strategy was to change in 1783 when the first branch opened to serve tobacco importers and distributors in Glasgow. The Royal Bank of Scotland then pursued the amalgamation process that swept through British banking and specific actions of this strategy included (see further Ellis, 1987 and RBS, 1993):

- Acquisition of Western Bank accelerates branch growth in Scotland (1857).
- First retail branch in London (1874).
- Purchase interest in Glyn, Mills & Co. (1905).
- Acquisition of Drummonds Bank accelerates branch growth in England (1924).
- Acquisition of William Deacon’s Bank provides access to London Clearing House (1930).
- Amalgamation with The National Commercial Bank of Scotland provides further branch growth in British isles (1969).

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[2] This section borrows freely from RBS (1993).

- National and Commercial Banking Group is formed, that is, a holding company to control Royal Bank of Scotland, Glyn, Mills & Co. and William Deacon's Bank (1969).
- Merger of Glyn, Mills & Co., William Deacon's Bank and The National Bank into Williams & Glyn's Bank, that is, a single franchise in the London Clearing House (1970).
- Full merger with Williams & Glyn's Bank and The Royal Bank of Scotland Group is formed (1985).

As a result of acquisitions and its own growth, the bank developed a network of retail branches throughout England, Wales and Scotland. A very important element of the geographic growth was that The Royal held a stake in Glyn, Mills & Co., since early in the century and gained control of it in the 1970s. As a result of a stock market merger (in 1985), The Royal's branch network grew to some 860 outlets, 540 of which were in Scotland and 320 distributed between England and Wales (Ellis, 1987:24).

During the 1970s, business north of the border flourished as The Royal Bank of Scotland engaged in lending activities for businesses dealing with North Sea oil and gas. At the same time, overseas interests developed. For instance, merchant banking activities were established in Singapore and Indonesia; branches opened in New York and Hong Kong; and representative offices in Houston, San Francisco, Chicago and Los Angeles were opened.

At the end of the 1970s, what was to become The Royal Bank of Scotland Group had approximately 40% of the Scottish banking market, 15 to 20 percent of England's North West region and 4 to 5% of the total UK market (Hoschka, 1993:229). However the growth potential of its main market was sombre, as the Scottish population had been slowly decreasing[3]. This together with internal problems created strong pressures to find new growth opportunities.

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[3] From 1985 to 1993 the Scottish population fell from 9.1 to 8.8% of the UK total (as documented in Nielsen, 1994). During that same period, averaged weekly expenditure per person was £107.75 sterling in Scotland or 4.24% below the English average of £112.32 sterling (idem.).

Lack of Growth Opportunities and Faile Take-over Attempts

At the end of 1979, Lloyds Bank had accumulated a 16.4% stake in the capital of the National and Commercial Banking Group (The Royal Bank of Scotland's parent company). National and Commercial and Lloyds had joint control of an international factoring company called Lloyds and Scottish Plc (each held about 40% of the stock), and Lloyds made a merger approach to acquire the National and Commercial Group. The Scottish Board preferred to enter discussions with Standard Chartered Bank (another British bank with strong overseas business). After these discussions were made public in 1981, the Chinese Hong Kong and Shanghai Banking Corporation made a bid which was referred to the Monopolies and Merger Commission (MMC), who, in turn, decided that neither bid was in public interest (The Banker, 01-VI-1986, p. 10).

The contest for The Royal Bank of Scotland came at a time when major rationalisations were affecting many of Scotland's financial institutions. The Board of The Royal played a "Scottish" card in arranging a defence and thus, evoked a Scottish named successor. As a result, The Royal Bank of Scotland successfully rejected the takeover and its managers were more fortunate than those at other Scottish companies such as Coats Patons, Anderson Strathclyde, North British Steel, United Wire or Disullen (see further The Herald, 23-IX-93).

After the failed take-over episode, The Royal's manager had an incentive to change the course of the company because the bank was still vulnerable to a take over. Within months of MMC's ruling a new corporate strategy was announced and this new strategy characterised by:

- Amalgamations .- Acquisition of all the capital of Williams & Glyn's Bank in 1985.
- Merchant banking activities .-Through the acquisition of Charterhouse Group in 1985.
- Bankassurance .- Managers explored motor insurance through Direct Line Insurance (1985), established a joint venture with Scottish Equitable to sell life assurance through RBS branches (1990), and developed advisory services within the established branch network through Royal Bank Insurance Consultants (1991).

- Cross-border growth .- Managers positioned Citizens Bank (US subsidiary) as the largest commercial bank in the North East of the USA (1988).
- Cross-border alliance .- Managers take actions to make future hostile bids more difficult by share exchange with Banco Santander (1988).

The strategy initiated in 1985 received renewed strength when in 1989, the Rt. Hon. George Younger was appointed to the Board of the Group. His career had been in politics and government, culminating as Secretary of State for Scotland. Lord Younger was named Chairman of the bank in 1990. Shortly after, he and his management team engaged in a new major drive to carry out strategic change and improve the bank's performance. The new strategy sought to achieve competitive advantage in retail finance through bankassurance, growth in the US, use of IT to gain critical mass in selected markets and an agreement with Banco Santander. The new strategic focus together with bad debts in the early 1990s' recession were responsible for merchant banking activities (under the form of Charterhouse Group) to be sold in 1993, and staff reduced by 4,400 for the whole group (or 22% less than those in 1991). As a result, the bank's strategic focus emerged with an emphasis on retail, corporate and personal banking.

The Royal Bank of Scotland was then able to regain its competitive positioning. In the fiscal-year 1994 the bank achieved a 52.2% cost-income ratio. Even though accounting information included the effects of Direct Line, the bank's cost-income ratio was one of the lowest ratios in the UK bank sector (Financial Times, 1-XII-95). In 1994, profits before tax reached £532 million, a record high in The Royal's 267 year history (RBS, 1994). In 1995, The Royal Bank of Scotland had assets of over £49 billion which made it number 101 in the world and Britain's sixth largest (RBS, 1995). The bank employed approximately 20,000 persons and had 720 branches, in more or less equal numbers on each side of the Scottish-English border.

Geographical Diversification and the Agreement with Banco Santander

In the 1980s, The Royal followed other British banks and established operations in the USA. In 1988 the bank acquired and made Citizens Financial Group a wholly-owned subsidiary. This Rhode Island-based group offered retail banking services in New England. Through Citizen, The Royal Bank of Scotland became one of the few

British banks to have a successful diversification into the US (The Sunday Times, 5-IX-93). However, and in response to the mid-1990s pressure for consolidation in US banking, Bank of Ireland approached the Royal Bank with a view to merge Citizens Financial with Bank of Ireland's First New Hampshire. The merger aimed to:

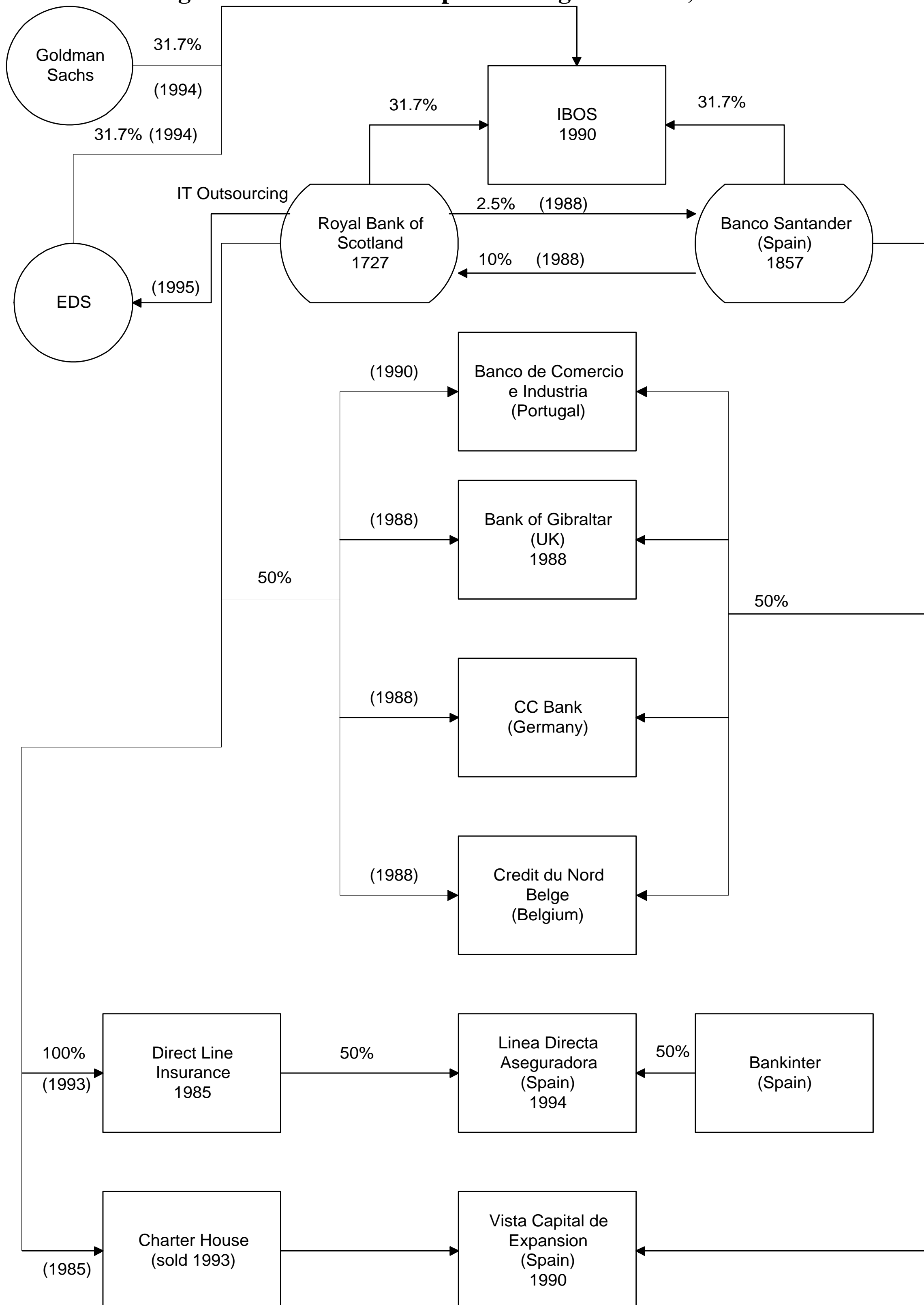
> "...enable both banks a stronger presence and forgo selling to one of the larger New England banks." (Financial Times, 1-XII-95).

Shortly after, both US banks amalgamated (to trade under the Citizens Financial name) into a $14.4 billion dollar company (see further The Times, 19-XII-96). The Royal would hold a controlling interest or a 76.5% of the capital, and at the time, this move created the third largest commercial bank in New England.

In the 1980s The Royal Bank of Scotland's international banking presence in Europe was practically non-existent and limited to branches in Piraeus (Greece) and Zürich (Switzerland) to handle their shipping business (RBS, 1993b). Its international presence was limited to branches in New York and Hong Kong, and representative offices in major cities (Singapore, Jakarta, Houston, San Francisco and Los Angeles). To further increase their international assets, the bank considered opening representative offices, branches abroad, acquiring a foreign bank or engaging in a strategic alliance (Hoschka, 1993:229). Foreign direct investment was discarded as too costly in terms of shareholder value (idem). Instead an alliance took place with Spain's then fourth largest bank. Banco Santander became The Royal's biggest shareholder by increasing its stake to 10 percent in 1988. In a corresponding transaction, The Royal received 2.5% of Santander's stock (RBS, 1989). See figure 1.

The alliance allowed The Royal's managers to pursue the geographical diversification move initiated in 1985 because the alliance established the well-capitalised Santander to stand by as "white knight" to prevent another hostile bid. As a result of the alliance a joint bank was established in Gibraltar to provide off-shore facilities and serve expatriates. The Royal also took 50% interest in some of Santander's private banking subsidiaries in Belgium and Germany (see further Hoschka, 1993:323). In 1990 the private banking portfolio increased when both partners gained control of the Portuguese Banco de Comerçio e Industria.

Figure 1: Stakeholder Map of Strategic Alliance, 1995



Source: Annual Reports, author.

Key: (X) = Year of acquisition.
X = Year of establishment.
% = Percent stake in financial capital.

In spite of these deals to reinforce the original strategic rationale, the alliance did not open a route to higher growth diversification into the private or corporate banking sector. Banco Santander concentrated on international corporate banking by increasing Banco Santander de Negocios' market share in Spain, Latin America and particularly Asian emerging markets such as the Philippines, rather than on its joint private and corporate banking activities with The Royal in Europe. However, the Royal-Santander alliance had important collaboration in the retail finance sector. In 1990 Santander and Royal Bank of Scotland launched IBOS (Inter Bank On-Line System) in an attempt to develop an independent pan-European system for retail banking transactions (more below).

Information Technology at the Royal Bank of Scotland

A major product of the 1988 cross-share agreement between The Royal Bank of Scotland and Banco Santander was the creation of IBOS. However, IBOS was another in a number of IT innovations of The Royal Bank (see further Fincham et al., 1994). These innovations included managing own and second party ATM networks to develop one of the busiest cash dispenser networks in the world (RBS, 1993). The bank also used its IT expertise to generate handling fees for third party credit card processing (a system called RoyNet). As a result, selected IT innovations of The Royal Bank of Scotland in the 1970 to 1990 period also included:

- First British bank to put its branch network direct (on-line) with a central computer (1973).
- ATM network begins at Williams and Glyn's Bank (1974).
- RoyNet – System for credit card transaction handling services (1985).
- RoyLine – Desktop banking system for businesses (1987).

IBOS was launched by The Royal Bank and Banco Santander with the aim of becoming the nucleus of a Pan-European retail banking system and to provide fast, reliable and cheap, small cross-border transactions. The initial strategic goal of IBOS was to capture the retail market in cross-border transactions. This consisted primarily of transactions from wealthy individuals, small and medium-sized enterprises. The partners claimed that IBOS aimed to go beyond a link between data processing

systems or a cross-border enlargement of ATM networks and thus, contest other cross-border payment systems.

The system allowed money transfers between customer accounts within 24 hours, versus the 7 day lag for other European banks not involved in SWIFT or American Express transfers. The system had a £1 million daily limit for money transfers abroad (£3,000 when initiated abroad) and £10,000 for standing orders. The system also allowed customers to check their balance at a foreign (member) bank, at a cost to the customer of £1.00 sterling.

IBOS extended membership to other European banks including Crédit Commerciale de France and Banco de Comerçio e Industria (Portugal) in 1992. However, The Royal Bank of Scotland and Banco Santander held major stock interests in these banks as well as in some of those that subscribed from Belgium, Germany and Gibraltar.

A major turning point was when Chase Manhattan Bank (US) subscribed to IBOS during the last quarter of 1995. The entry of the latter underlined the way IBOS provided a vehicle for small, low IT-investment banks to develop international retail payment capabilities that matched previously capital intensive scale international networks. IBOS then became a credible alternative to other interbank data exchange systems such as SWIFT (a Belgium-based consortium established in 1977) or Citibank's £200 million network. By skipping other cross-border payment systems IBOS could deliver low cost and reliable cross-border retail financial services. It offered an alternative channel to access opportunities in Europe, without requiring further spending by banks' shareholders. Global coverage became the objective of the IBOS partners as EDS, a US-based IT developer and outsourcing firm, purchased 31.7% and turned into the managing partner (1994).

However, after the last reorganisation IBOS's growth rate stalled. EDS was keen to open the network to other banks but existing members wanted to keep it exclusive and as a source of differentiation and (potential) competitive advantage. In what follows the discussion presents greater detail on how The Royal gained a competitive edge in UK banking markets. But rather than gaining it through IBOS, The Royal gained competitive advantage through a subsidiary called Direct Line Insurance.

DIRECT LINE INSURANCE

Scope of Bankassurance at The Royal Bank of Scotland

The first European bank to make a direct challenge to insurance companies was Britain's Trustee Saving Bank in 1967 (Hoschka, 1993:13). The Royal Bank of Scotland and many other European banks followed this diversification path as they sought to capitalise on cross-selling opportunities to the existing customer base.

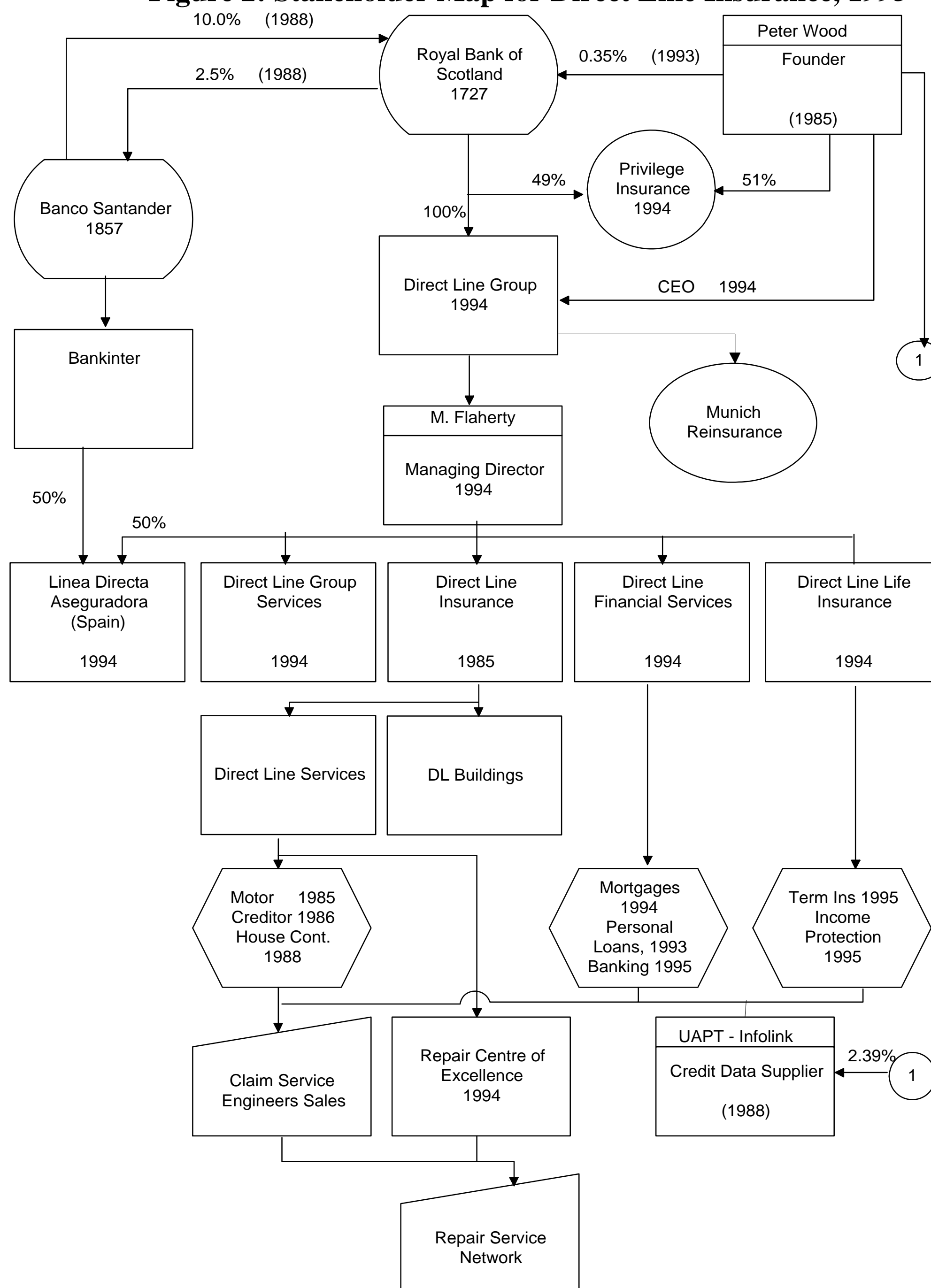
The scope of The Royal's business in bankassurance was not limited to motor insurance. Bankassurance included a joint venture with Scottish Equitable Life Assurance Society. This was called Royal Scottish Assurance and sold life insurance products through the branches of The Royal Bank of Scotland from 1990 onwards. Another subsidiary aiming to increase cross-selling opportunities was an independent adviser (Royal Bank Insurance Consultants). This firm was established in 1991 to supply general insurance to both individuals and corporations.

On the other hand, in 1985 The Royal Bank of Scotland Group Insurance Co Ltd was established and subsequently renamed Direct Line in 1988, this was one of the insurance subsidiaries of The Royal Bank of Scotland (RBS, 1993b). Its original aim was to sell motor insurance over the telephone. The subsidiary started with 63 employees and £20 million capital provided by the Royal Bank of Scotland (increased in stages to £155 million in 1993 in the form of subordinate debt with no recourse to Royal Bank of Scotland.)

> Direct Line "...was the first insurance company to use the telephone as its primary sales tool. Cutting out middlemen and commissions by selling insurance direct to the public." (DL, 1995b).

By 1985 British financial circles had observed the performance of branch-less intermediaries (Girobank, established in 1968) and were aware of the possibilities offered by phone-banking (pioneered in 1979 by US banks). However, contrary to previous North American and British experiences Direct Line's business and margin rose rapidly between 1987 and 1994. In November 1994, 2.2 million motor policies were in force. At the time, Direct Line employed 2,857 persons (around 10% of the parent company). Growth from scratch to these numbers positioned Direct Line as the largest-ever personal motor insurance company in the UK (DL, 1994). See figure 2.

Figure 2: Stakeholder Map for Direct Line Insurance, 1995



Source: Company reports, author.

Key : (X) = Year of acquisition (capital structure and organisation in 1995).
X = Year of establishment.
% = Percent stake in financial capital.

Growth in Business Portfolio (from Motor Insurance to Pension Funds)

By mid-1993 Direct Line's overall strategy had captured approximately 10% of the motor insurance market. Direct Line had overtaken all the composites and was the most successful motor cover provider. The growth of Direct Line in terms of regional centres and product lines included creditor insurance (1986), house contents insurance (1988), personal non-secured loans (1989), mortgage loans (1993), its own car repair centre (1994), income protection insurance (1995) and life (term) insurance (1995). This growth illustrates how Direct Line diversified from motor insurance to banking services like savings and deposit taking (for the latter a license was granted in 1995 for operations in 1996 and was initially used to sell investment funds).

Geographic growth of the business portfolio built from a south London location (1985) towards Glasgow (1989), Manchester (1990), Birmingham (1992), Leeds (1994), Bristol (1995) and a joint venture in Madrid (1995). Geographic growth suggests that even though IT applications and telephone distribution gave Direct Line the possibility of national operations right from the start, managers decided to concentrate in selected markets (Senior Manager, 30-IX-96). Careful selection of geographic and product market growth used the brand name as key point for the firm to diversify products within the retail financial services markets. Growth at Direct Line leveraged on extensive use of marketing, accumulated experience and customer goodwill in a strategy that emphasised high levels of cross selling to established customers (see further Geroski, 1991:163). The strategy, however, was not invariably successful. Extensions to mortgages and credit insurance had mixed results because their start up phase took longer to achieve critical mass than motor insurance. An important element, in this product market move, was whether to inherit on-going businesses from The Royal Bank of Scotland as these portfolios contained more variety that Direct Line’s motor business:

> "The mortgage book for the bank and Direct Line was completely separate and continues to be. There was no cannibalism and the same applies to savings deposits." (Senior Manager of RBS, 26-IX-96).

Synergy and market positioning were the reason why separate franchises were kept and which allowed Direct Line to generate its own businesses because:

> "When Direct Line Financial services was created there was not risk to cannibalise. The bank had a small market share (about 4%) [of mortgages and credit insurance markets], so Direct Line had 96% of the market to grow. Second, as a group we expected to acquire more customers than through any single one institution." (Senior Manager of DL, 30-IX-96).

As a result, managers at Direct Line used the bank's business as a source of information to design their databases. Once operational, managers tried to keep separate and distinct activities. The decision to keep separate databases emerged from The Royal's management board and aimed to focus each subsidiary on its core markets and core capabilities rather than a single institution attempting to establish a single sales force, that cross-sells all products to all market segments. Succinctly, managers of The Royal aimed to keep organisational flexibility while they aimed to capture cost efficiency and integrate subsidiaries around strategic objectives.

STRATEGY FOR COMPETITIVE ADVANTAGE

Financial Performance of Direct Line Insurance

The success of Direct Line has been attributed to the result of four distinctive forces (financial performance, innovative IT applications, focused marketing and quality service), of which financial performance was the most important. Three factors created superior financial performance, namely the expense ratio, pricing policies and retention rates and the financial investment strategy. The expense ratio fell below 16% by 1993, establishing the lowest cost ratio among the providers of retail insurance.

Data in table 2 suggests that Direct Line's low total expense ratios resulted from growth of substantial scale economies emerging from its IT-based platform rather than from a labour-based platform (Channon, 1993:2). Direct Line was able to increase income and business volume without increasing labour costs (and particularly between 1992 and 1993). As a result, between 1989 and 1995 business volume grew at an average annual rate of 31%, while total expenses grew only at an average of 25% per annum. This produced a steadily increased margin and a declining cost ratio.

Table 2: Relative Financial Performance of Direct Line, 1989-1993

	1989	*1990*	*1991*	*1992*	*1993*	*Average*
Total Expense Ratio						
Direct Line	30.15%	31.15%	26.21%	20.97%	13.77%	24.45%
Agency Writers	29.50%	29.50%	29.90%	30.20%	29.70%	29.80%
Direct Writers	21.50%	21.90%	22.50%	22.50%	22.40%	22.20%
Claims to Premium						
Direct Line	65.50%	68.84%	71.85%	74.04%	66.77%	69.40%
Agency Writers	78.50%	78.80%	79.00%	85.00%	78.30%	79.90%
Direct Writers	86.30%	86.60%	83.70%	91.70%	80.90%	85.80%

Source: Breaking the Mould (16-VII-94), author.

The second element of Direct Line’s financial performance was its combination of pricing policies and retention rates. “Instant insurance” (i.e. insurance cover provided over the telephone and without agents), saved Direct Line’s customers up to 20 percent on premium. But to translate "instant insurance" into superior financial performance, Direct Line required a very high retention rate. This was evident when in 1993 Direct Line achieved an 85.8% year-to-year customer retention ratio. For that same year, the sector’s average retention rate was between 50 and 60 percent (Marketing Week, 25-III-94).

On the other hand, Direct Line's proceeds from investment income was seldom mentioned as a feature of the company's successful financial performance. As can be observed in table 3, between 1989 and 1993 investment income represented an average 30.28% of the annual profit after tax (and less than 20% since 1993). The result was remarkable when compared with other insurers, which received all or more than all of their profits from investment income (more below).

Table 3: Selected Financial Ratios for Direct Line Insurance, 1989-1995

	1989	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*Average*
Profit growth (before tax)	N.A.	10.99%	24.79%	19.87%	69.92%	43.40%	17.79%	31.13%
Growth of total expenses	N.A.	21.09%	17.17%	28.60%	45.29%	25.24%	16.83%	25.70%
Investment income/profit (b/t)	40.74%	51.65%	38.84%	40.40%	16.73%	12.85%	10.75%	30.28%
Motor policies '000	255.5	293.0	410.7	670.2	1,254.5	1,883.9	2,200.0	995.4
Home policies '000	81.1	114.2	164.2	205.9	273.1	523.0	725.0	298.1
Total '000	336.6	407.2	574.9	876.1	1,527.6	2,406.9	2,925.0	1,293.5
Annual Growth	*N.A.*	*17.34%*	*29.17%*	*34.38%*	*42.65%*	*36.53%*	*17.71%*	29.63%
Year end staff	526	643	787	1,086	1,903	2,857	2,746	1,507
Avr total expense/employee	41,255	42,768	42,186	42,818	44,666	39,797	49,782	43,324
Avr total assets/employee	205.32	211.51	257.81	279.83	308.46	302.91	391.59	279.63

Source: Annual Reports, author.

According to Keynote (1997:53), long-term business, motor and travel insurance are the markets where traditional insures (i.e. composites) have met head on with competition from bank-distributed insurance (i.e. bankassurance). The life and pensions or long-term business is the largest market for UK-based insurance companies and premium income of long-term business emerging from Britain represents some 80% of total business (idem, p. 54). Between 1992 and 1995, UK premium income of long-term business rose by 3.8% whereas overseas life and pensions premium income rose by 23.1%. At the same time, between 1992 and 1995 long-term insurance investments rose by 51.7% and the income that the investment generated went up by 39.5% (idem, p. 14). Clearly, growth for UK-based insurance companies is linked to developing more overseas long-term business premium income and continuing to invest in ordinary stocks and shares.

Direct Line's financial investment policy was quite different to the portfolio of life and general insurance companies. Direct Line's management claimed that in motor insurance liabilities arise very quickly and, therefore, the ups and downs of the stock market could not provide for good risk management. Management believed that equity investment "doubled" the firm's risk exposure (Peter Wood in Channon-Cox, 1993). Nonetheless, there were more profitable investments other than government bonds and with less risk than equity. Therefore, this was a customer-oriented

company which was in a position to make money out of premium income as opposed to other insurance firms that required investment income to turn a profit.

Redefining Market Structure

Prior to 1985, insurance brokers displayed premium values of different insurers grouped in tables and according to the underlying asset (risk) to be insured (home contents, motor, etc.). Customers could then compare premiums at different companies and these premiums were known as the "standard rate" (The Guardian, 6I-X-95). Direct Line's telephone distribution changed the scheme through which customers discovered actual quotes as brokers approached insurance companies on their behalf (Financial Times, 7-VIII-95). Direct Line's quotes were made available over the telephone, instantly and on a stand alone basis (i.e. without reference to competitors as insurance brokers did). In fact, this pricing approach ended the existence of the "standard rate" and insurance prices started bearing closer resemblance to a direct-insurer's cost structure, portfolio risk and customer's characteristics.

But, Direct Line was not the first to by-pass brokers as a distribution channel. The first British firm to sell insurance directly to customers was established in 1961. Abbey Life aimed at combining Canadian sales techniques with more comprehensive and easier to understand life insurance policies (BusinessAge, 1-IX-93). Regardless of the opportunity, during the following 34 years composites drifted to a kind of wholesaler role (Lloyds List, 26-IV-95). Retailing was surrendered to independent intermediaries (called insurance brokers). As a result, when banks and building societies entered insurance as brokers or direct issuers they found that composites lacked the advantage of controlled, pre-established distribution channels to sell insurance. The eventual success of Direct Line gave the composites a technology-based way to fight-back other financial intermediaries and recuperating some of their lost market share. However and as will be made evident below, technology also threatened the relationship between insurance firms and brokers which few established insurance firms were willing to change.

The earliest follower of Direct Line was established in 1988, in the form of a subsidiary of Royal Insurance called The Insurance Service. Royal Insurance gave the new subsidiary a distinct name from the rest of the group in order to avoid upsetting

brokers with whom it had a working relationship. However, Royal Insurance began selling personal cover directly over the telephone in 1994, using its own brand name, and simultaneously through The Insurance Service. The end result was that support of the parent's advertising benefited Royal Insurance Direct while The Insurance Service scored badly in recognition tests (Financial Times, 16-VIII-95).

Table 4 illustrates the growth of other insurance companies (and banks) using the same technology as Direct Line to sell directly to customers in retail finance markets. It then becomes clear that Direct Line's innovative entry had modified core products and redefined the market's structure (see further Geroski, 1991:210). Further evidence of Direct Line’s influence on selling retail financial products emerged when, in the course of 1989 and 1990, 50 direct insurers were established in the UK. This was two years after Royal Insurance’s experience and when Direct Line’s superior financial performance was evident. The proliferation of direct underwriting centres in Britain was such that in 1994 they captured approximately 31% of the private motor insurance market, up from 17% in 1992 (Breaking the Mould, 16-VIII-94).

Many of Direct Line's followers were telesales arms of traditional insurers and alongside their telesales subsidiaries, many composites continued selling policies through brokers. Composites believed that the establishment of telesales outfits created conflicts with insurance brokers and with their brand image (Lloyds List, 26-IV-95). Insurers' lack of confidence reflected doubts about mastering the new "direct" channel and also, the poor management of brokers as a distribution channel.

In brief, one external element that allowed Direct Line to achieve competitive advantage had to do with the fact that composites' response to Direct Line was not immediate.

> "To be honest I didn't expect the industry to make it so easy for [Direct Line]. They ignored us for so long." (Peter Wood in BusinessAge, 1-IV-95).

The five year lag in the response cost insurance companies dearly in terms of investments to develop adequate capabilities (specially related to IT and direct advertisement.) However, the experience of The Insurance Service suggested that building these capabilities was a necessary but not sufficient condition to regain credibility and market share.

Direct Line's strategy illustrates a case where an innovative entrant surmounted apparently high entry barriers by essentially changing the terms under which competition occurred. Direct Line's technology could be (and was) adopted by a wide range of firms supplying retail finance both inside and outside Britain. Telephone call centres opened a distribution option and one that allowed even the smallest competitors to challenge retail finance markets by setting-up direct sales operations on a variable basis.

Table 4: Selection of Direct Retail Finance Intermediaries, 1986-1996

Name	*Type*	*Owner*	*Country*	*Est.*
Direct Line	Motor, mortgages, life	Royal Bank of Scotland	UK	1985
Celtic Autoquote	Motor	Celtic Insurance	Ireland	1988
The Insurance Service	Motor, home	Royal Insurance	UK	1988
GA Direct	Motor, home, personal	General Accident	UK	1988
First Direct	Bank	Midland Bank	UK	1989
Churchill Insurance	Motor, home, credit cards	Wintherthur (CH)	UK	1989
Eagle Star Direct	Motor	Eagle Star	UK	1989
Premier Direct	Bank, insurance (1994)	Bank of Ireland	Ireland	1990
Royal Insurance Direct	Life	Royal Insurance	UK	1992
Touchline	Motor	General Minister	UK	1992
Admiral Insurance	Motor	Brockbank Group	UK	1993
Alliance Auto Direct	Motor	Alliance Insurance	UK	1993
Guardian Direct	Personal	Guardian Royal Exchange	UK	1994
Banco 1	Bank	Unibanco	Brazil	1995
Línea Directa	Motor	Bankinter/Direct Line	Spain	1995
Chase Direct	Bank	Chase Manhattan Bank (NY)	USA	1995
Chem Direct	Bank	Chemical Bank (NY)	USA	1995
Guardian Direct	Motor	Guardian Direct (UK)	Ireland	1995
Virgin Direct	Investment funds (Peps)	R Branson/Norwich Union	UK	1995
Privilege Insurance	High risk motor	P Wood/RBS	UK	1995
Banque Directe	Bank	Banque Paribas	France	1995
Norwich Union Direct	Motor, home	Norwich Union	UK	1996

Source: Financial Times, The Sunday Business Post, author.

The Innovative Applications of Direct Line

Alongside pricing policy and the response of competitors, another distinctive element that explained Direct Line's success was its innovative IT applications and their support to improve customer service. The three most common features associated with these applications were :

- Interactive systems .- Contracts indexed by customer name rather than by number.
- Fair quotes .- Relevant information to process claims and policies was retrieved from actual telephone conversations by queries made in a polite but precise manner.
- Enhanced customer convenience .- Retrieved information was directly transferred into actual policy formats (if quote accepted and paid through direct debit or credit card). The client then foregoes the need to fill in forms or wrestle with paperwork.

These features suggests that interactive systems supported a separation of all pricing elements and conferred the possibility of examining the value chain from quote to settlement. Secondly, fair quotes produce more accurate information on the risk represented by type of customer profile since there is reduced risk of adverse selection. Thirdly, direct methods improve customer convenience and result in higher retention rates than other distribution methods.

The end result of direct operation was that Direct Line's top management did not need to ask anybody for information because information could be retrieved from the system. Any query was possible as long as it was supported by the database which reflects the importance and time spent on its design by Direct Line's original team.

At Direct Line all IT was integrated and the database stored information from all over the firm precisely when a transaction took place. As a consequence, Direct Line's managers had a direct channel to craft strategy without any of the uncertainty about profit drives and policy variables that generally applied. They could experience the effects of changes in IT or risk assessment queries on a real-time basis. Direct Line's strategy makes no need of middle management to process information about environmental conditions or strategy implementation and hence, was not subject to information delay or bias inherent in other situations. This de-layering of operations

meant that approximately 80% of the 3,000 strong workforce were involved in front-desk operations like telesales, teleclaims or claim evaluation (Channon, 1993:10).

The 1988 entry into home contents insurance illustrates how the anticipated advantage attributed to IT systems was explored to support a diversification move. Building societies had an advantage in terms of previous market knowledge. To add to this difficulty, Direct Line inherited a sub-scale book of business from The Royal Bank of Scotland which had major problems of adverse selection (security properties) and under-valuation. For a time, claim ratios and costs at Direct Line exceeded those of the main competitors in the home contents insurance market. Differences in claims ratios and costs evidently reflected under-priced high risk and under-priced business rather than the standard business attracted in motor insurance (Peter Wood in Channon-Cox, 1993). However, even a non-optimal portfolio responded to the new process. Direct Line's system supported a fast learning curve which allowed managers to fine tune the pricing policy and, eventually, learnt how to price home contents insurance more accurately than building societies. In the end, home contents insurance proved to be another success story for Direct Line.

Transferring Competencies to the Royal Bank of Scotland

The results of Direct Line's financial success and innovative IT applications became a learning experience for The Royal Bank of Scotland. The phenomenon roots back to the early 1980s. At the time, Peter Wood was a director at Alexander Howden (a UK insurance firm). There he conceived the idea for an outfit such as Direct Line. His employer was not interested and so he resigned.

> Peter Wood "...approached a number of other institutions before he made his way to..." The Royal Bank of Scotland (The Guardian, 25-XI-94). The people at The Royal "...weren't too worried about losing £20 million, more about losing reputation. But in the end, they just wanted to try something new so they backed me....The bank kept a very close watch on its new investment for a good five years, before a new chief executive, George Matthewson, took over. He quickly realised the potential of Direct Line, and was happy to let [me] run the show.. Now he asks me for advice on how to make money. I have to say: 'Sorry I'd love to, but I'm too busy'." (Peter Wood in BusinessAge, 1-IV-95).

One lesson from Direct Line to managers at the bank was not depending solely on Management Information Systems to discover new growth opportunities. Rather, managers must rely on having good IT and being able to apply information systems to pursue new growth opportunities (Senior Manager, 26-IX-96). Direct Line managers considered that the source of their competitive advantage could not be reduced to IT providing cost-effective solutions. Rather they believed that Direct Line competitive edge emerged from successful execution of a product market and a customer group diversification move within retail finance markets.

DISCUSSION

This research illustrates how a subsidiary of the Royal Bank of Scotland called Direct Line Insurance captured an opportunity presented by technological change. This strategy seemed to offer the added benefit of greater cost efficiency. For managers of the Royal Bank of Scotland IT appeared to lower entry and exit barriers and promised high sustainability of competitive advantage. The strategic intent behind the case study of the Royal Bank of Scotland suggested competitive considerations were at a premium because unsolicited take-over bids in the early 1980s put pressure on managers to create growth opportunities. On balance the strategy seemed to have been more effectively executed in some areas than in others while cost efficiency through IT capabilities played a secondary role. Nevertheless, technological change did allow the Royal Bank of Scotland to enter other geographies and new markets.

Managers of the Royal Bank of Scotland seem to have developed their plans for strategic control in a relatively stable environment in British retail insurance markets. However, managers at Royal Bank of Scotland were under pressure to create several new growth opportunities and taken advantage of regulatory change in Western Europe (i.e. the Single Market in Financial Services programme). But in spite of European and British regulatory changes during the 1980s and early 1990s, the main success of The Royal Bank of Scotland in retail financial services and a factor which changed the whole strategy of the bank, came not from geographical and product diversification strategies nor from IBOS and other international alternatives. Success emerged from product based diversification through a telephone-based operation in motor insurance. This success demonstrated new possibilities in the provision of retail

financial services and showed a new use of IT applications to implement banks' corporate strategy.

The Royal Bank of Scotland was primarily a low risk follower, aiming to deflect further unsolicited take-over bids. To The Royal's managers, the fact that Direct Line redefined the rules of competitive engagement would be beneficial since it did not create a threat to any of The Royal's potential predators.

The subsidiary started as one of the alternative entries into bankassurance explored by managers of The Royal. Direct Line was established not as a product of The Royal's internal ingenuity since they were approached only after the founder failed to find finance opportunities amongst established insurers. Initially a tactical innovation designed to supply a limited set of retail financial services, Direct Line evolved to create a new distribution channel that posed a major threat to the strategies and market position of other financial intermediaries. This was a case where an innovative entrant surmounted apparently high entry barriers by essentially changing the terms under which competition occurred. Direct Line's characteristic technology and marketing provided The Royal Bank of Scotland with a swift and profitable penetration of the UK insurance business. Furthermore, this technology was successfully replicated (with the same results) in countries such as Spain and Germany.

For established insurance firms, Direct Line's financial results raised the issue of whether core capabilities in retail insurance encompassed underwriting or underwriting and investment management. Increasing profitability from Direct Line's premium income suggested that diversification moves of other insurance companies into investment management (and their reliance on investment income for profits) had turned a core business unprofitable. Insurance companies increased the profitability of a previously unprofitable core business as insurance companies adopted telephone technology. The technology gave insurance companies a way to fight back the entry of banks and building societies to retail insurance markets and the possibility to profit from premium writing (rather than investment income). However, it took the visionary strategy of Direct Line's founder rather than the previously unprofitable tactical entry of The Royal Bank into bankassurance, for established insurers to capture new growth opportunities associated with telephone sales (such as improved market segmentation possibilities through a new distribution channel).

The unanswered issue is why Direct Line was not internationalised more quickly. In terms of growth opportunities there seem to be few limitations either from managerial diseconomies or with computer capacity. Yet Direct Line used a strategic alliance to penetrate the Spanish market. The alliance would suggest the possibility that regulatory approval and compliance were perceived as barriers to entry in spite of the EU Single Market reform programme. As a result, future research on the adoption of technological change in financial markets (and in particular, IT applications in retail banking) should further explore how regulatory approval and compliance are barriers to enter bank markets. Moreover, how environmental change modified the adoption of alternative, equally effective, cost reducing, IT-based applications by bank managers.

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