Local and regional banking: The ugly implications of EMU

General Thematic 4: The Economic and Monetary Union

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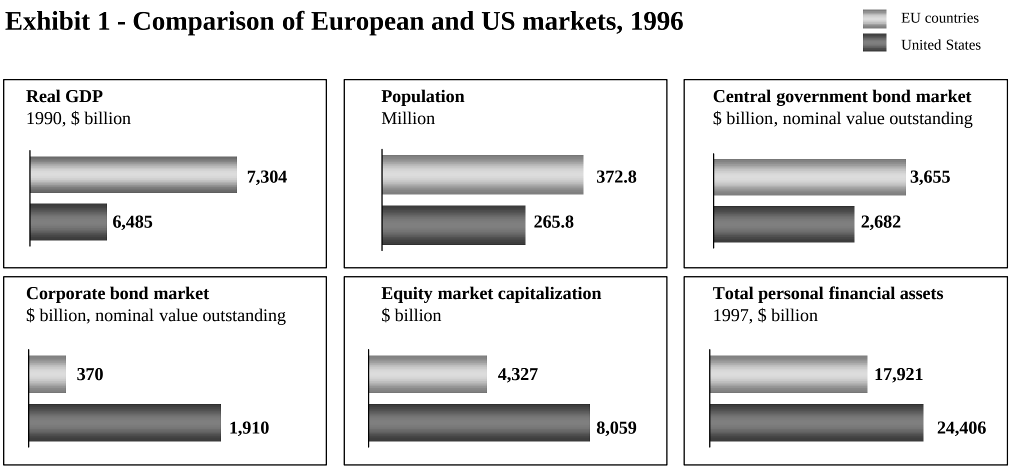
Crisis is a productive state provided
you do not associate it with catastrophe.
(Max Frisch)

The sceptics said it would never happen. But in May 1998 Europe's heads of government selected 11 countries to adopt the euro, which became an official currency in 1999 and be phased in over three years. Astonishingly, many banks remain ill prepared. Although most of them have tackled the IT and operational challenges raised by a single European currency, especially local and regional banks in Germany have failed to address the more difficult strategic issues. Put bluntly, they have not considered how they will prosper once a single currency and the evolved structural changes in competition wipe out great chunks of profit in their traditional businesses. These businesses accounted for between 40 and 80 percent of a local and regional bank's revenue.

To European banks as a whole, that revenue is worth approximately $ 100 billion; in less than a decade, it could be slashed to $ 77 billion. Unless the banks can merge with their neighbours in space and restructure their cost base, the overall decline in profits could be even steeper.

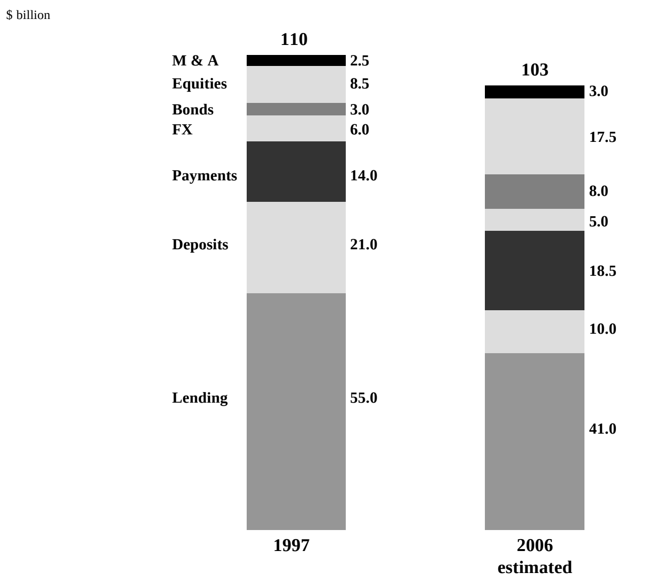
EMU will, of course, also create growth opportunities. If the political, economic and monetary objectives of monetary union are met, the euro could come to challenge the US Dollar as the world's primary reserve currency, while the pooling of Europe's national securities could create a capital market to rival north America's (exhibit 1).

Exhibit 1 - Comparison of European and US markets, 1996



But the best opportunities in this new, vibrant market will probably fall to no more than a handful of banks. Revenue growth in wholesale banking will be concentrated in the investment banking businesses of equities, bonds, and mergers and acquisitions – areas in which most banks will be hard pressed to match the skills and global reach of the US investment banks already operating in Europe. In 1997 business in these areas is worth approximately $ 14 billion. In less than a decade it could be worth $ 29 billion (exh. 2).

Exhibit 2 - Impact on Europe‘s wholesale banking revenue pool



Overall, EMU is likely to create more losers than winners in wholesale banking. Banks that wish to survive in this harsh new environment should wake up to this dark reality, an rethink their strategies.

A. Threats in wholesale banking

Certain competitive gaps could open between those European banks whose national governments participate in EMU, and remaining European banks. But even more worrying is the impact EMU will have on the industry as a whole. The three traditional areas of wholesale business are under threat:

A1. Foreign exchange

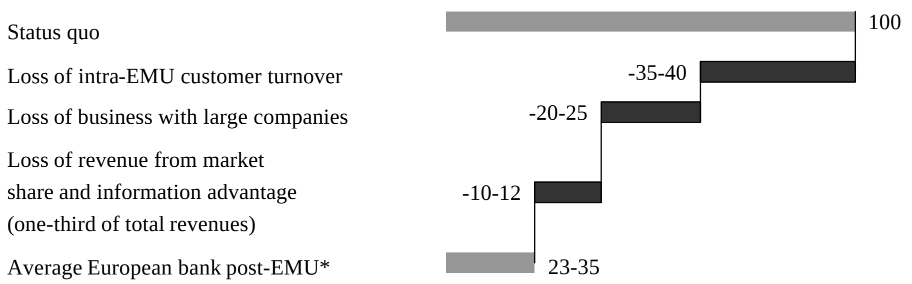
The European foreign exchange market currently sees daily turnover of $ 798 billion (including noneuropean currencies), from which European banks earn $ 6 to $ 8 billion a year in total net revenues. The lion's share of this business is taken by the largest commercial banks, which dominate foreign exchange trade in their domestic currencies.

Huge trading flows help keep the cost of serving clients relatively low and give the banks the market information and clout to help them profit from their own position-taking.

Following EMU, however, most European banks can expect a massive decline in foreign exchange revenues and profits (exhibit 3).

Exhibit 3 - Impact on foreign exchange revenues

Example: Average European bank
Index: 1997 = 100



* Estimated

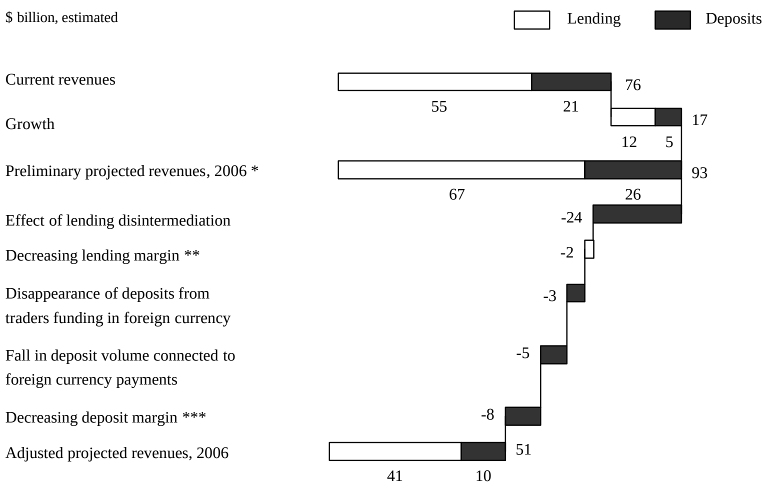
Intra-European currency trading, worth about $ 3 billion in revenues a year, will simply disappear. At the moment, this trade accounts for 35 to 40 percent of an average European banks foreign exchange revenue, although for some banks that mainly trade their domestic currencies against other European currencies - particularly those in southern Europe - it represents a good deal more. The average bank will also see a further fall in revenues of 30 to 37 percent, because even if it currently enjoys significant market share in trading domestic currency, it may turn out to be a relatively small player in the European market. It will therefore lose the scale advantages that helped it win the business of large corporate and institutional customers and profit from position-taking.

All in all, the typical European bank in terms of asset size looks set to lose about 70 percent of foreign exchange trading revenues when national currencies are abolished, leading inevitably to a rapid shakeout in the industry. Banks that succeed in becoming large-volume Euro dealers will then be able to prize more and more business away from smaller institutions, leading a market in which business is eventually consolidated among a few key competitors whose scale advantages offset the downward pressure on margins. In effect, it will resemble the US market, in which only 6 banks have foreign exchange revenues exceeding $ 100 million. In Europe, more than 13 banks currently occupy this bracket.

A2. Corporate banking

Corporate banking - which includes the lending, deposits, and clearing business - was worth about $ 90 billion in Europe in 1996. Some $ 76 billion of this was accounted for by lending and deposits alone. Without EMU, these two businesses could grow by another 20 percent over the next 10 years. With EMU; revenues will shrink to as little as $ 50 billion (exhibit 4).

Exhibit 4 - Impact on corporate lending and deposit revenues



* Proportionate to GDP at 2% per annum in real terms
** Projection forward of historical margins decrease 1986-96 (-0.5%)
*** -10% per annum

Corporate lending overcapacity and intense competition have prompted European banks to offer corporations extremely cheap loans. Bank loans are consequently a leading source of finance for European corporations. (In the United States, 7 percent of non-financial companies' liabilities are in the form of bank loans; in Europe, the figure is 11 percent.)

These changes arise not just because of EMU. Banks are focussing more on shareholders, and beginning to use access capital to buy backshares rather than lend at barely profitable rates. Governments are keen to improve competitiveness by eliminating state subsidies to banks (common in such countries as Austria) and preventing them from offering preferential rates to companies in which they hold stakes.

As for the pressures exerted by monetary union, the new European Central Bank (ECB) looks set to impose reserve requirements on commercial banks within EMU, the cost of which will probably be passed on to customers in form of higher lending rates. Add to this decreation of a single, more liquid European corporate bond market, and it seems likely that most large corporations will find it cheaper to raise debt through bond issues. The disintermediation of this corporate business could reduce potential lending revenues from $ 67 billion to about $ 43 billion.

Competition for the new structure in corporate lending business will be fierce. The largest, best-capitalized commercial banks that can themselves raise money at low costs will be the most favourably placed to offer competitive rates to the small and medium-sized businesses that still need bank loans. The reduction of lending margins because of competition could have a further $ 2 to $ 3 billion from corporate lending revenues, bringing the final figure down to about $ 41 billion.

The deposit and money market business in 1997 is worth about $ 21 billion, and without EMU might have grown to $ 26 billion over the next 10 years. With EMU, volumes fall because corporate customers will no longer need to hold deposit accounts for each European currency in which they trade, and traders will no longer use the money market to take advantage of interest rate differentials between the currencies of EMU member countries. As a result, deposit revenues will fall by about $ 8 billion.

Margins will also shrink because of stiff competition for the remaining business. As in the foreign exchange markets, the advantage held (and the profits enjoyed) by the typical European commercial bank in its domestic money market will disappear. Such banks will then have to vie with many other players in a huge Euro money market. The winners will be large banks with cost-efficient centralized trading, economies of scale, and superior market information. Margin compression and loss of revenues from position-taking will probably reduce revenue earned in the money market by a further $ 8 billion. Business will be consolidated among a few large institutions.

The European payments business in 1997 is worth $ 14 billion. Much of this comes from correspondent banking business, whereby banks hold accounts with other banks in order to make and receive payments in foreign currencies. EMU will eliminate intra-european currency payments, while the introduction of TARGET, a clearing system that enables EMU member banks to make payments directly to one another in real time, will further reduce the need for traditional correspondent banking services. Nonetheless, overall cross-border payments will rise as cross-border trade continues to grow, so that revenues could reach $ 18.5 billion by 2006.

In these markets too, larger institutions with economies of scale will win shares from smaller, less efficient banks. Again, there will be a few big winners and many losers.

A3. Government bond trading

Banks operating in Europe currently generate revenues of $ 2 to $ 3 billion a year by trading government bonds on customers' behalf. But the bank's own investments in its government bonds have also been an important source of revenue and profits, particularly in the run-up to EMU. 1998, one leading Portuguese commercial bank holds a quarter of its assets in government bonds that yield an estimated 12 percent. Over the past 3 years, the cost of funding this portfolio has fallen by about 6 percentage points as interest rates have converged in the countdown to EMU. The result has been a sharp increase in net revenues from the portfolio. Indeed, it has probably been the main driver of the banks' recent profit growth.

Take away these one-off games, however, and the post-EMU outlook is bleak for many banks in the government bond market. EU government debts stood at $ 6.3 trillion at the end of 1997. Reducing each participating government's debt to 60 percent of GDP (as stipulated in the Maastricht Treaty) implies a reduction in outstanding debt of $ 1.1 trillion, or 18 percent (assuming no further debt issuance). This will not happen by January 1999 but the figures indicate the trend toward fewer debt issues, more competition for selling and trading that debt, and slimmer margins. Approximately $ 2 to $ 3 billion of revenue will have to be shared between only a handful of large-volume institutions.

In addition, domestic banks will no longer win business on the basis of specialist knowledge of their national currencies and interest rates. Historically, most investors have traded European government bonds according to currency movements. But once the foreign exchange risk is removed, the focus will be entirely on credits (i.e., one country's credit risk versus another's). The winning banks will thus be those that can effectively sell "credit stories" rather than "foreign exchange stories". Europe's market will in a sense resemble the US market. It will be dominated by investment banks whose size enables them to profit on slim margins, and which have a reputation for credit analysis, partner-networks and sales capabilities born of experience in the huge US corporate bond market.

B. Opportunities

Although there are threats a plenty, EMU will also create growth opportunities in European wholesale banking. A single currency will produce a European capital market far more liquid than any existing national European market, stimulating the municipal and corporate bond markets as well as the equity market. It will also prompt the cross-border consolidation of many industries, generating mergers and acquisitions and consulting business. Investment and consulting banking and securities products and services will therefore be in great demand.

B1. Municipal and corporate bonds

Although the Maastricht Treaty will constrain the issuance of government bonds, EMU should promote a European corporate and municipal bond market. The former is almost non-existent, but the latter is already beginning to show signs of growth. In Italy, for example, several cities and regions have issued bonds to fund local infrastructure projects.

In an aera of monetary restraint, the funding of large public infrastructure projects such as hospitals and roads will increasingly be transferred to the private sector. Some of this funding will be raised by privatizing assets currently owned by governments (i.e., by equity financing), but a substantial proportion is likely to originate in the bond market, because the stable revenues and capital value of many infrastructure projects make them low credit risks that can be sold to investors without recourse to government backing. The debt issuer might be a privatized company or a single-purpose funding vehicle. Either way, these debt issues represent a massive opportunity for investment banks' bond businesses.

Another possibility is the development of a US-style municipal bond market to replace government borrowing. Municipal bonds enable local authorities to issue debt without central government garanties; to stimulate demand, the authorities offer investors tax incentives. The market currently accounts for 40 percent to total new debt issues in the United States each year, which suggests what the potential of this form of government debt "privatization" might be. If the European market were to reach a similar level of maturity, it could generate approximately $ 3.3 billion in revenues for banks in the form of origination fees and trading income. Judging by US experience, municipal bonds could also be one of the few areas in which European banks - even small ones - succeed in competing with leading investment banks. Although large banks operate in the US municipal bond market, many smaller regional banks are also leading participants, having capitalized on their local presence to forge links with local government authorities. In EMU, European banks have a similar advantage in a continental municipal bond market.

To date, corporate bonds have been a significant source of capital for companies in most European countries. But a single more liquid European corporate bond market with a bigger pool of potential investors will reduce the cost of entering the market - and possibly the cost of borrowing - and thereby encourage a move away from bank loans as a mean of financing. If European corporations were to use bonds to finance their debt to the same extent as US corporations (where bonds account for 19 percent of total liabilities), the European corporate debt market could generate additional revenues of $ 2.2 billion a year in origination fees and trading income. This revenue would accrue to institutions such as US investment banks that have strong corporate bond origination and structuring and pricing capabilities, and to institutions that have good relationships with corporate issuers.

It has been argued that European corporate bond market will never shrive because issues need to be large - perhaps as big as $ 100 million - to attract adequate attention from investors, and few European companies can raise this kind of finance. But an analysis of the US corporate bond market shows that 69 percent of all issues (31 percent of total market value) are smaller than $ 100 million. Indeed, 46 percent of issues are under $ 50 million. It would therefore seem that there is little to hinder the development of a healthy corporate bond market in Europe.

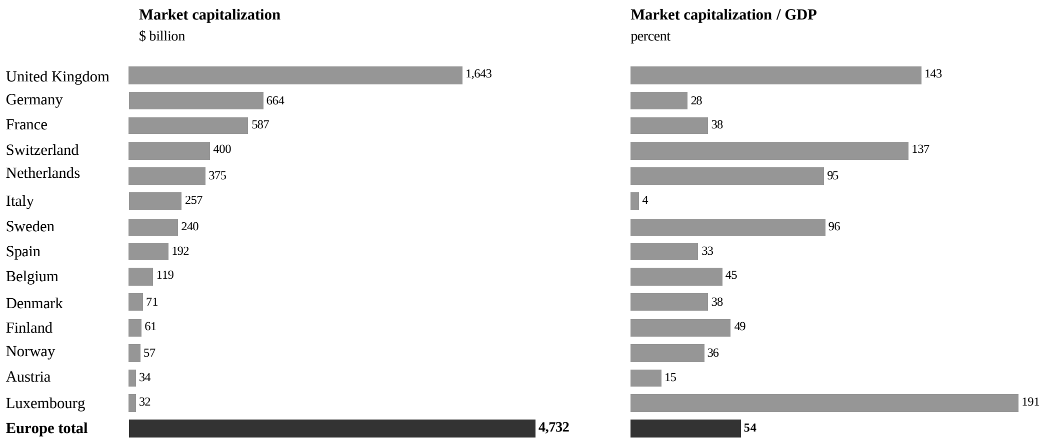
As the market evolves, so will the market for higher-yielding corporate paper. A single currency and strict monetary discipline will mean Europe's government bond market will offer few opportunities to investors seeking high risks and high returns. This is likely to prompt demand for debt issued by companies with greater credit risk - a high-margin and therefore attractive market segment for banks that have strong credit analysis, structuring, and monitoring skills. The US high-yield corporate bond market is already shriving, giving US investment banks the chance to acquire experience in this area.

B2. Equities

Equity markets in the United Kingdom, Switzerland, Sweden, and the Netherlands are relatively mature (exhibit 5), with market capitalization to GDP ratios in line with those of the United States. Elsewhere in Europe, they are less well developped. There are two reasons. First, supply has been limited by high corporate tax rates in some countries (encouraging companies to remain private in order to shelter income in off-shore accounts), and by the availability of cheap bank loans. Second, investor demand for equities has been constrained by a lack of large institutional pension funds, and by the availability of high-yielding government bonds.

Nevertheless, a single European equity market is poised for tremendous growth. The overwhelming burden that state-funded pension schemes plays on government budgets, combined with EMU's constraints on government borrowing will accelerate pension reform and the birth of private pension schemes. These schemes will flood equity markets with funds looking for relatively high long-term returns.

Exhibit 5 - Size of European stock markets, 1996

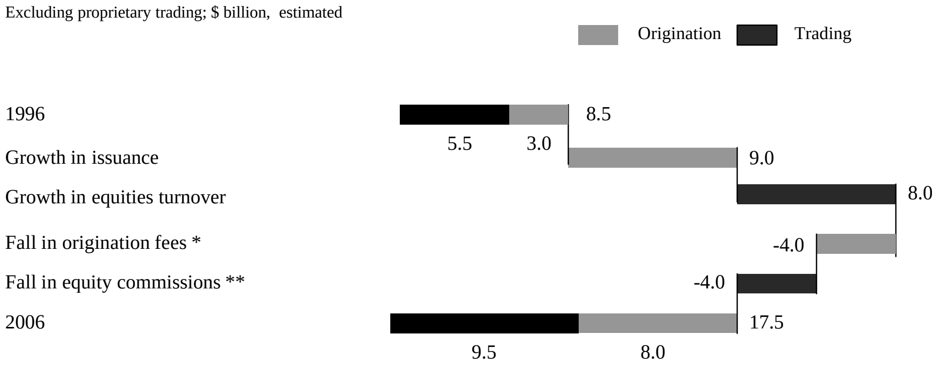


EMU will also increase the supply of equities. Again, by a constraining government debt issuance, EMU will encourage the privatization of state-owned industry (privatizations worth $ 125 billion are expected to come to market 1998-2003). In addition, medium-sized European corporations are expected to start making public offerings. Growth may prove critical to the survival of many of them when a single currency finally eliminates entry barriers, and equity could be a ready source of capital. There are about 20,000 private European companies with a turnover over $ 50 to $ 250 million, all potential IPO candidates.

Which banks benefit from this growth in supply will depend on the size of the issue. In the case of larger privatizations, the winners are likely to be integrated, top-tier investment banks that can originate and distribute issues globally. In the middle-market segment, there may be opportunities for reasonably sophisticated regional and local banks that can leverage strong corporate relationships. One of the EMU's most immediate effects will be the shift, the asset allocation of many investors from a national domestic focus to a pan-european sector focus. A German institutional investor, say, might currently hold as much as 90 percent of its equities portfolio in German stocks. To reflect the German market's capitalization in a pan-european market, that share would have to be reduced to 25 percent. This rebalancing will generate enormous business for brokers. Those best placed to capture it will be the large, pan-european brokers with sector-focussed research departments able to meet the needs of investors who, with the removal of national financing boundaries, increasingly want to assess and compare European equities on a sector basis.

However, growth in business volumes will be offset by sustained pressure on origination fees and selling commissions (exhibit 6). This may deter institutions that have not already got strong equity capabilities and a top-notch research function from competing in the market, given the high cost of building the necessary skills (exhibit 7).

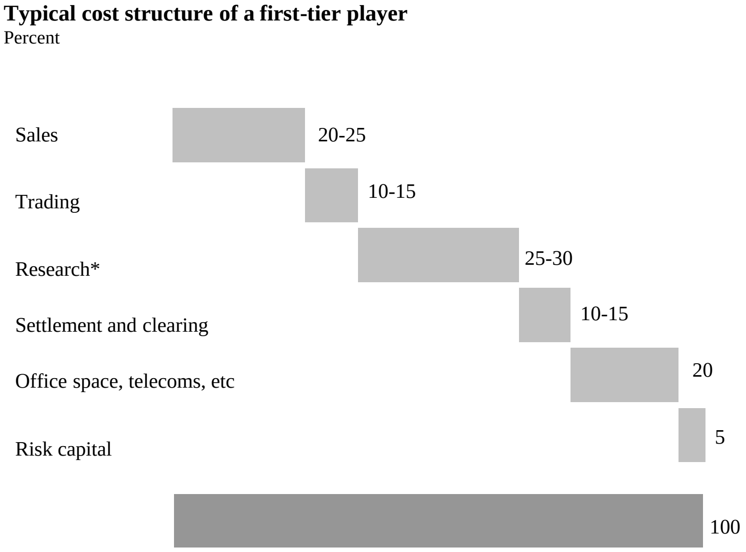
Exhibit 6 -Revenue potential in European equity



* international fees (currently 3.5%) are likely to come down to the level of domestic fees (2%)

** approx. -20%

Exhibit 7 - Cost structure of equities trading



* 75% of all research costs; 25% are allocated to corporate finance

Source: *Nelson's Directory of Investment Managers*; McKinsey analysis

B4. Consulting and M & A services

EMU is likely to create a notable increase in demand for consulting and M & A services. Although a single European market in terms of free trade has existed since 1992, the expected cross-border consolidation will, however, be an important catalyst. With investors using the best corporate performers on the continent as their benchmark, many of Europe's industries will have to restructure to close productivity gaps. Companies with limited domestic growth opportunities will also be more eager to venture into other European markets when currency risk is eliminated, especially in industries where there are economies of scale to exploit.

The banks best positioned to take advantage of this increase in demand for M & A and consulting services will be multiproduct institutions with strong strategic relationships, M & A expertise, sector expertise, and, above all, cross-border networks. Revenues could reach more than $ 3 billion by 2006.

C. Post-EMU banking strategies

European banks can be segmented according to the scope of their wholesale businesses and their geographic reach. They fall into three categories:

1. global aspirants,
2. national players (those that have ventured outside their domestic market on the basis of a specific expertise, such as Spanish banks using their cultural connections to expand in Latin America), and
3. local and regional players.

Their starting positions largely determine the strategic possibilities open to them within a monetary union.

1. Global aspirants

The global aspirants are the top-tier of European wholesale banks. Their wholesale businesses, covering abroad a ray of markets and geographic regions, account for up to 80 percent of revenues. They have invested heavily to build abilities in many key investment banking markets and to forge relationships with corporate issuers of securities and institutional investors.

Yet half of the six or so European banks that aspire to leading positions in the European market are likely to be disappointed. As already stated, big banks will have the greatest advantages within EMU. But size alone will not suffice. The ultimate winners must be able to assume leadership in several different wholesale markets and meet the range of needs of corporate issuers and institutional investors in different products, currencies, and geographies.

In this respect, the leading US investment banks already enjoy advantages over European banks in the race for leadership in Europe. To begin with, their home market is huge and highly profitable, giving them substantial ressources for expansion. In addition, their access to investors in North American market appeals to large European corporate issuers. Even now, through alliances and mergers, they are investing to a correct and apparent weakness: their lack of retail distribution capabilities. Most important, their integrated culture, sustained through organic growth, has enabled them to provide effective service to clients accross currencies, regions, and product markets.

By contrast, European aspirants are plagued with problems. Although they may be strong in traditional wholesale banking, their expertise in key investment banking products such as equity, origination and advisory services is patchy. The lack of credible US securities business is also seen by many as a fundamental weakness, given that US investors represent about 60 percent of the global investor pool for securities. European aspirants therefore need to make massive investments in their equity and advisory businesses, and then be prepared for returns to materialize only slowly, since profitability is likely to be low or non-existent until a bank reaches a position of leadership. Finally, because European aspirants have built their investment businesses by hiring from other banks and making mergers, they face challenges in integrating disparate cultures.

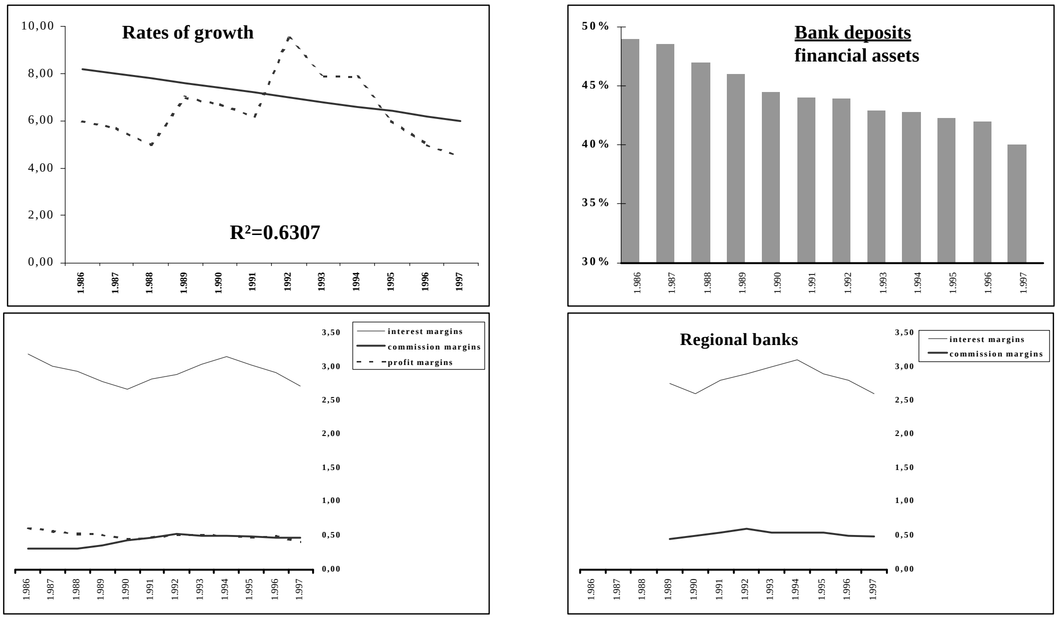
So what are the options for these banks, assuming that there will be only seven or eight leading investment banks operating in Europe, and that four or five US institutions already command an almost unassailable lead? The main strategic question they must ask is whether they should invest in building a position in US securities, a vital component of leadership in investment banking. This could be achieved by merging a whole bank, by entering some form of joint venture with a US bank, or by acquiring a series of components. All of these options would be expensive, but precedents indicate that an organic built-up in the United States is unlikely to work. Bank shareholders will therefore have to decide whether they wish to gamble still more on efforts to build an integrated investment bank.

It may be, however, that leadership of some of the traditional wholesale businesses is more profitable and more nearly within the reach of Europe's global aspirants than leadership in the hotly contested investment banking businesses. In the interests of shareholders, banks should thus ask themselves whether it would be wiser to build on existing strength and competitive advantages - such as a strong balance sheet, good corporate relationships, treasury market capabilities (in foreign exchange and money markets), or experience in fixed income, payments, and lending - in order to become a leader in one or more of these fields.

2. National players

Like global aspirants, national players are wholesale driven rather than retail-focussed, deriving approximately 60 to 70 percent of their revenues from wholesale activities. However, their international operations are limited and their equity and advisory businesses even weaker than those of global aspirants. After EMU, these banks will no longer be able to rely on the profits from trading their own investment portfolios to drive their businesses. Competition in all their traditional markets will intensify, volumes and margins will fall, and they will suffer from a competitive disadvantage because of their lack of scale.

Exhibit 8 - German banks‘ evolution path and earnings under pressure



One option for a bank in this position would be to sell all or part of its wholesale investment business to a player willing to pay for its capabilities and market position. However, the pace of consolidation in the industry and the overlap among players means it might not be easy to find buyers for such a business, nor indeed jobs for its employees. Two further options would be to try to build a purely pan-European position, or to adopt a niche position. The former would be difficult in view of the investment needed, the insensity of competition from US banks and global aspirants, and the questionable viability of such a strategy. The latter option is more feasible. But banks adopting it would have to identify their niches as early as possible to fill the gap left by the decline of their traditional wholesale businesses.

National banks need to examine their current customer franchise to identify areas in which they have advantages. Some may be well positioned to serve the middle-market corporations that top-tier investment banks cannot serve economically. Others might be useful to an industry's sector with specialized needs. German banks, for example, could be well placed to the machinery or chemical sector specialists, since the industry is dominated by German-based corporations.

Product markets should be examined in the same light. Could a bank, for example, build a specialist position in the high-yielding segment of the corporate bond market? And what about geographic focus? Could a bank perhaps exploit corporate and institutional client business spanning European and emerging markets? Some German and Austrian banks already have strong commercial banking operations in Eastern Europe on which they might be able to build investment banking business.

3. Local and regional players

Local and regional players, especially Geno-Banks and Sparkassen in Germany, are retail banks first and formost. Traditional wholesale banking generates only 30 to 40 percent of their revenues and their investment banking capabilities are relatively insignificant. These banks should consider withdrawing altogether from wholesale banking into retail banking. The drawback of this strategy is that in an area of pension reform, even retail clients will want mutual fund products and equity brokerage services from their banks. Local players might, therefore, have to form strategic alliances or mergers in order to provide a universal banking frange of products and services in space.

The only other option for these institutions is to focus on a specific niche (such as middle-market corporate lending and deposits). The choice will be economically limited, as in most cases these banks' advantages will amount only to a few technical skills, a strong but deteriorating corporate franchise, and some local market knowhow. Moreover, the niches in which they possess advantages may not be very large, which would mean scaling down considerably.

Especially the promise of lower transaction costs, increased sales productivity, and more convenient services has lured traditional banks into a setting-up of new electronic and product-specific channels. But they have quickly found that their delivery capabilities are outstripping the traditional branch-centered model they used to manage them (exhibit 9).

Exhibit 9a - Estimated channel usage by bank customers

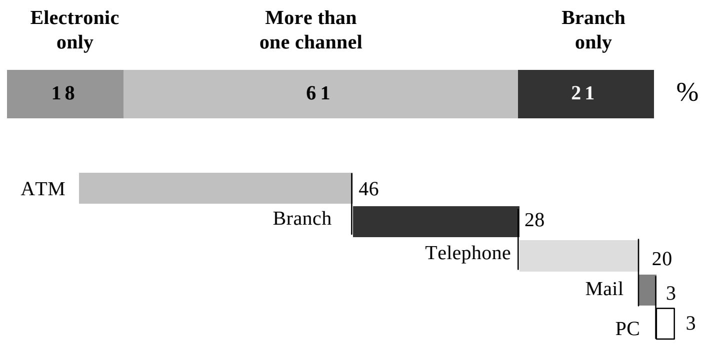


Exhibit 9b - Market structure in German banking sector

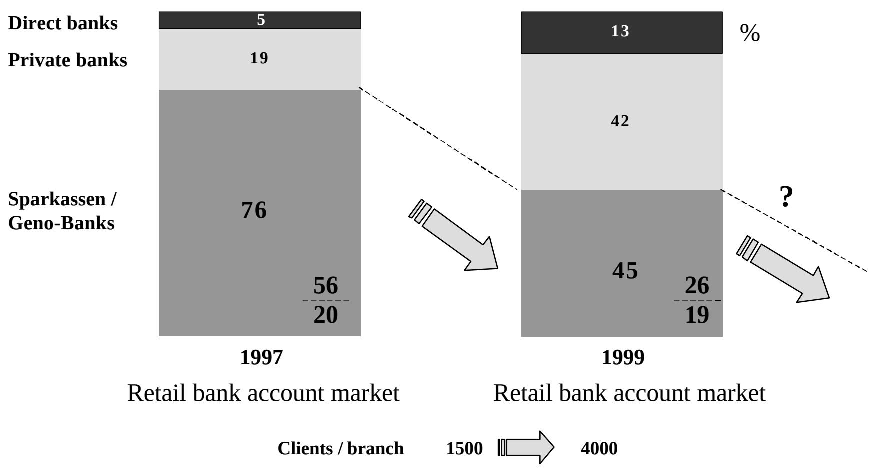


Exhibit 9c - Structure of direct-banking-services-demand

Clients in million

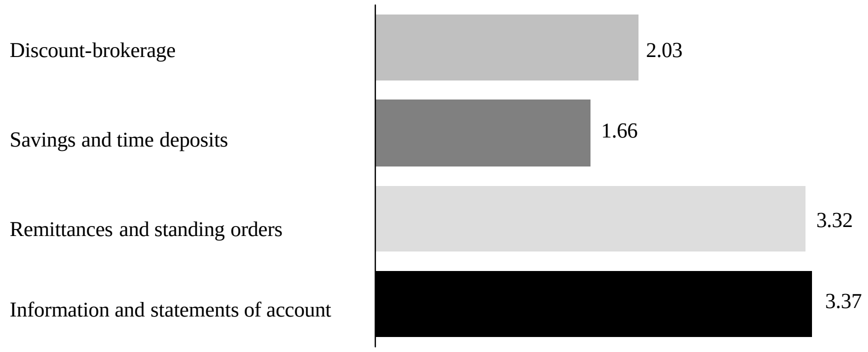


Exhibit 9d - Reasons for online and internet banking

Percentage

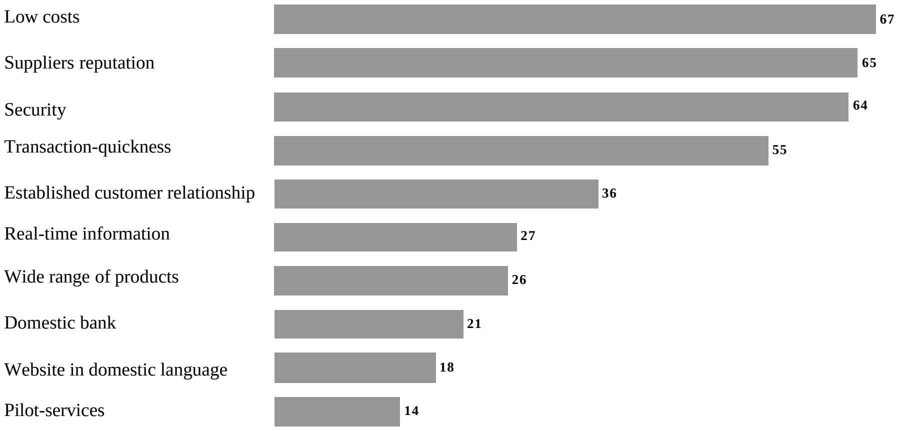
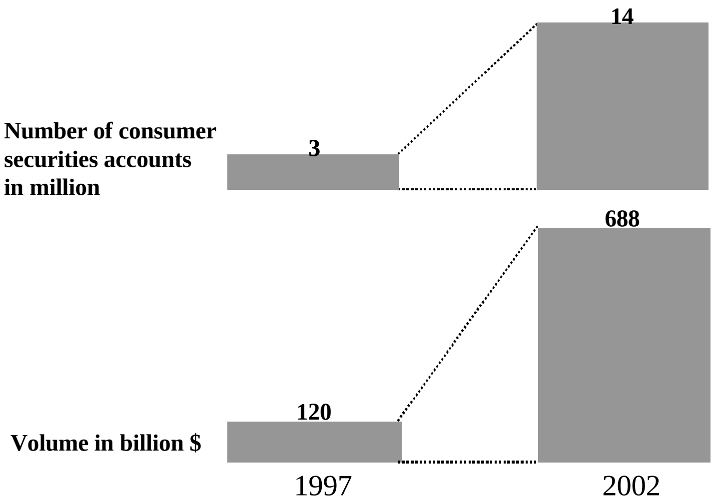
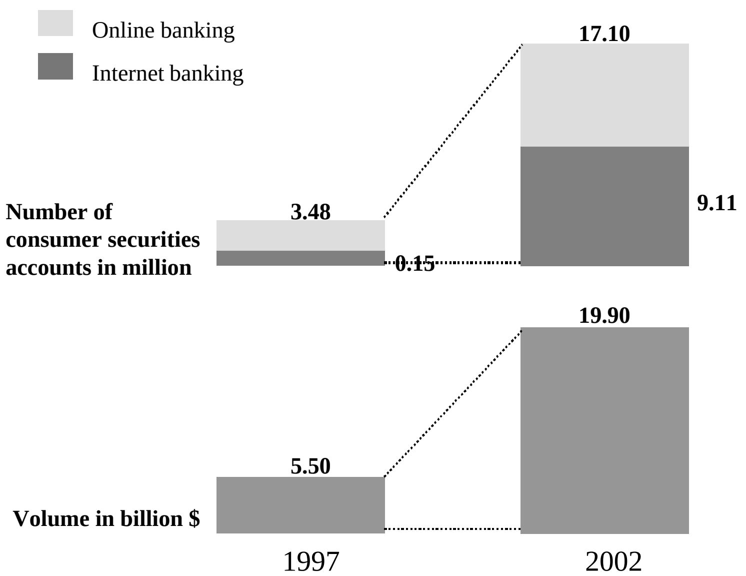


Exhibit 9e - Highly estimated growth rates for internet brokerage and online-banking in Germany





As a result, they face stubbornly high efficiency ratios, expected revenues that never materialize, and general managers at odds with the standards by which they are measured and rewarded. To resolve these problems, regional and local banks must adopt a new approach to the management of multiple channels. In particular, they must address four issues:

1. Who owns the customer?
2. How are operational issues resolved?
3. How are managers measured and rewarded?
4. Where does each business fit?

1. Customer ownership

The notion that customers can be "owned" is championed by branch managers seeking to preserve a branch-centered organisation. They maintain that the branch remains the prime point of contact for sales, service, and relationship management. But their argument does not stand up to close scrutiny. Far from staying local to a branch, most customers today use a number of channels.

They graze from ATM to telephone to branch, depending on their needs at any given time. They are no more "owned" by a banking channel that they are by a TV channel. If a bank designing a multichannel organisation persists in assuming that a channel can own customers, it is deluding itself about how customers use banks and the range of choices they enjoy.

2. Operational issues

This familiar refrain is sounded by advocates of "customer-centered" management. For them, locl and regional retail banks should be organised around customer segments, and those who manage these segments should dictate what products and services are available and how they are delivered. But this approach can be dangerous. Most delivery channels are used by several customer segments, and a channel decision made by a manager of one of them could at worsely affect other segments. Say the owner of a mass-market segment directed branch tellers to encourage these customers to use ATMs. If the tellers inadvertently encouraged mass-affluent customers to do the same, they might prompt unwanted defections among these customers.

Resolving operational issues such as how products in channels will be offered to target customers must be an explicit part of multichannel management design. It is also likely to require CEO involvement, for two reasons:

First, decisions on these issues help to shape a bank's customer value proposition. Will customers enjoy universal access to the full portfolio of channels, for example, or will there be incentives (or disincentives) to use certain channels?

Second, a decision that is optimal for a business units perspective may not be optimal for the institution as a whole. The CEO must be involved in decisions such as:

Can dedicated product delivery platforms, such as investment centers, develop their own brands independently of the banks umbrella brand? Can individual channels chose to distribute other providers' products, such as mutual funds an mortages, if they see a profit opportunity? Will the various sales forces be allowed to compete directly, or be required to collaborate?

3. Performance measurement and rewards

In a regional or local multichannel organisation, developping performance measures means:

1. Allocating accountability for profit and loss to the right people
2. Closely tracking the key economic drivers of the business, whether by channel, product or customer
3. Obtaining meaningful space, channel, product, cost, and revenue data from management information systems so that appropriate standards can be established.

One unfortunate legacy of the branch-centered system in space is that a customer's balances and revenues are normally allocated to branches, regardless of the channels actually used by the customer. As a result, the contribution of branches to the network is often overestimated, and that of newer channels underestimated. This means that the new channels have to depend on acquiring new customers for revenue, even when most of their customers are branch-based.

Allocating revenue to regional or local branches has two consequences: First, only the CEO bares all the responsibility for managing performance. Other senior managers are unable to find out how profitable their businesses really are. Second, banks lack the tools and measures to make informed decisions about resource allocation.

4. Structure and reporting

As banks add new channels to their delivery networks in space, it becomes harder for the branch-centered organisation to manage products, segments, and channels, and the connections between them. Decision-making slows down, issues get "kicked upstairs", and managers' view of how their businesses are performing is blinkered by unresponsive IT systems that have failed to keep pace with the evolving of the network.

Within the bank, leaders become more internally focussed. Instead of running their businesses, they get caught up in the issues and conflicts that arise because the decision-making framework does not match the complexity of their business. In one bank, all marketing decisions concerning products and delivery were still funnelled through a single strategic marketing group, despite the fact that the number of choices offered to costumers had increased five-fold in recent years. The group became a bottleneck and the focus of internal conflict as it tried to prioritize and reconcile the bank's marketing messages.

D. Possible models for regional and local banks to challenge the future

Any bank seeking to improve its channel management must explicitely address four key issues. For its organisational design, it can chose from three broad models on a scale that ranges from tight coordination to unfettered competition (exhibit 10).

Exhibit 10 - Three models for channel management

Increasing reliance on...

...Design ◄	Coordinated Channel model	Managed competition model	Competing channels model ► ...Market
	„Centralist: Coordination through hierarchy“	*„Federalist: Competition governed by central standards“*	*„Darwinist: Competing channel, product, and customer groups“*
Description	Clear hierarchy Branch as dominant profit center Prescribed channel roles Integrated capacity management	Management of a few critical product/channel customer interfaces Multiple profit centers and shared resources Clear rules and transfer pricing	Competing businesses (everyone has a P&L) Independent capability and infrastructure
What banks need to be good at	Customer-based value propositions Highly involved COO-type leadership Making decisions and tradeoffs based on multiple variables	Customer- and product-based value propositions Developed responsibility while managing complex product, service, and channel matrix Incentive design and transfer pricing	Product- and channel-based value propositions Line of business leadership and incentives Introducing next generation of winning businesses Selling

The choice of model will ultimately depend on the bank' s strategy (does it emphasize space units, customers or products?), its market position (low market share would argue for more aggressive competition between channels because the bank's objective is acquiring customers rather than increasing its share of wallet of existing customers), and its view of how the market is likely to evolve (for instance, the speed of product commoditization, changing customer needs, and the costs of complexity) (exhibit 11).

Exhibit 11 - Choosing the right model

Bias toward coordinated channels	**Starting position**	Bias toward competing channels
High	**Market share**	Low
Average	**Products**	Distinctive
Strong IT	**Capabilities**	Strong frontline sales
Concentrated oligopolies	**Marketplace**	Highly contested/ deregulated
	View of industry evolution	
Slow	**Commoditization of products**	Fast
Low	**Cost of complexity**	High
Advice seekers	**Client preferences**	Indiviual product/ service seekers

* * *

All banks face though decisions. Those most likely to be successful within EMU are those that recognize the speed and magnitude of the changes they face and launch bold programs to address both the threats and the opportunities. Especially regional and local banks in a sandwich position between a cost-driven competition of direct-banks and a know-how-value-driven competition of specialized global players will move in merger-era. This evolution will be accompanied by a deep reorganization of their distibution channnels, their internal structures and the sales territories in space. Changing investments in qualitative, personnrl and technological requirements, considering the benchmarks in competition will lead to a fundamental restructuring of Sparkassen and Geno-Banks in Europe.

For some, this will mean aggressive retrenchment, disposal of businesses, and a renewed focus on retail banking. For others, it will entail substantial investment in the development and implementation of national and/or global strategies to become market leaders. Banks that follow neither course will succeed only in destroying value for stakeholders and their surrounding economic network in space.

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