EFFECTS OF REGULATORY CHANGE ON EUROPEAN BANKS: A CASE STUDY ON THE STRATEGY AND STOCK MARKET PERFORMANCE OF LLOYDS BANK (1980-1993)

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ABSTRACT

This research project will present a qualitative and quantitative account of how Lloyds Bank emerged as the strongest UK bank in the 1990s -after being the weakest ten years earlier. Through a case study approach the research presents the genesis and performance of Lloyds Bank's response to new growth opportunities. Through econometric analysis (i.e. an event study) the research evaluates the strategic intent of Lloyds' managers but within the stock market context upon which that intent was published and pursued. The research results illustrate a bank achieving a dominant market position based on a strategy of geographic specialisation, product diversification, customer group diversification, creation of shareholder value and cost reduction. The bank's strategy favours withdrawal from global markets and consolidation of business lines to approach a climate of increasingly uncertain results from competitive strategy. Econometric analysis highlights a short-term perspective of Lloyds' strategy by stock market participants.

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1 INTRODUCTION

According to Bose-Morgan (1998), the Lloyds-TSB Group represents the hallmark of leadership, innovation and strategic management for British financial services firms (p. 99). By focusing on shareholder value creation the bank became the best at attracting capital, satisfying customers and looking after employees (p. 103) Indeed, the claim of Bose-Morgan (1998) was corroborated by a set of interviews in 1996 (see further Bátiz Lazo-Wood, 1999). In this survey 61% of British respondents perceived Lloyds as the bank setting the standards in UK bank markets while the other 39% benchmarked their performance against a pool indicators (rather than to the performance of a single organisation).

The research that follows further explored the claims made in Bose-Morgan (1998) and in particular, the realisation that Lloyds' focus on cost control resulted in a stock market performance over an above the average for companies in the FTSE index (p. 98). The research proceeds through a case study that assesses Lloyds' strategy as responding to both senior manager's strategic intent and external forces of change during the 1980s. These external forces of change are reckon to encompass a clear change in regulation, innovations in telecommunications and improved risk assessment techniques. These external forces of change were three simultaneous and mutually reinforcing trends that challenged retail banking services sector in Western Europe and North America (among others Gardener-Molyneux, 1990:98ff and Humphrey-Pulley, 1997:83). As a result of these external forces of change, the strategy of Lloyds Bank emerges as being based on the development of capabilities to cope with a more volatile and risky environment, greater local and foreign competition and technological change (and its impact on past and future investments).

The research proceeds as follows. Section 2 presents a brief summary of the major forces of external change in commercial banks' competitive milieu (i.e. regulation policy, international lending and smart use of IT). Section 3 offers a succinct review of Lloyds' history. Section 4 presents major changes in the bank's growth opportunities as reflected in the banks' diversification patterns and Lloyds' entry into bankassurance. Section 5 evaluates

Lloyds' competitive position in the early 1990s. Section 6 comprises some suggested conclusions regarding the effects of regulation policy over banks' geographic, product market and customer group diversification. Finally, section 7 presents the quantitative support to the discussion in the form of an appendix.

2 EXTERNAL CHANGE AND COMPETITIVE ENVIRONMENT IN BANKING

2.1.1 Trends in Regulation Policy

Much of the regulation framework for the financial systems in Western Europe and North America originated in the inter-war years in conjunction with the economic instability and recession of that period. Actively using commercial banks to achieve an indirect control of inflation developed after the second world war as a response to the overflow of liquidity and the Keynesian macro-economic policies being pursued (Borio-Filosa, 1994:4). Structural change during the late 1970s and 1980s sought to change this stance as monetary authorities retreated from direct to indirect control of the money supply. Following a policy change in 1979 in the US, regulators in several countries modified the long-standing policy of fixed or sticky interest rates and adjustments of the money supply to the business cycle. Instead, active use of interest rates was introduced to enact direct control of the money supply. As a result, bank lending ceased to act as the main tool for short-term liquidity control and interest were allowed to float and vary according to market forces. Regulators were then challenged to improve competition in bank markets (de Juan, 1995:11).

The aim of regulating commercial banks also changed with the internationalisation of bank customers because the growing use of cross-border financial products made regulators more concerned about the competitiveness of their banking sector (Morgan, 1997:15). Regulatory change aiming at greater competition in bank markets often responded to international treaty obligations such as the end of the Bretton Woods international monetary agreement, EU developments, IMF conditions, GATT related agreements, etc. Different countries adopted similar schemes which aimed to create a levelled playing field in which foreign, non-bank and non-finance institutions were able to provide retail financial services. Further measures also sought to increase the transparency of retail finance transactions and reinforce intermediaries' capital base. Other measures were designed to improve the

supervisory role of regulators while others (in countries such as the USA, the UK and Japan) policy measures were expected to create a demand for employment in the financial services sector (Morgan, 1997:14).

Regulation policy also eroded barriers between market segments allowing the entry of new types of competitors. Non-bank and non-finance intermediaries (like Marks and Spencer or GE Capital) explored opportunities in bank markets because they were running out of growth opportunities in their traditional business lines. These strategies aimed to increase the profitability of their customer base by creating opportunities to cross-sell retail services and other financial products.

In brief, the end result of regulatory change was that during the 1980s and early 1990s in most Western European and North American countries competition across financial markets intensified (Gardener-Molyneux, 1990:24 and Morgan, 1997:13). Competition in bank markets heightened as changes in regulation removed demarcation lines between market segments and lowered requirements for new establishments in bank markets. The overwhelming response of banks, non-banks, foreign banks and non-finance intermediaries was diversification. Established and new participants entered new product market segments- and new geographical segments of bank markets. Moreover, through diversification banks could have captured previously unexplored economies of scale or economies of scope.

2.1.2 Innovations in Information Technology

Interest rate liberalisation and free movement of capital modified not only the competitive milieu of commercial banks, but also their productive capabilities (as the relative price of capital became more volatile). Banks then had an incentive to use improved technology to identify and manage risk and therefore, successfully apply new technology. The result was another structural change that emerged as the 1980s evolved and this change being the use of technology becoming more demanding because of a new dimension of competitive equilibrium.

Innovations in hardware and software allowed banks to increase the diversity (and complexity) of both assets and liabilities. The use of new technologies (characterised by computer power and telecommunications) allowed banks to exercise more control over risk

while employing more standardised (and cheaper) labour. New technology was also used to:

- Establish alternative distribution channels for retail services through high-volume payment systems (like auto-teller machines or electronic point-of-sale devices);
- Improved administrative processes (clearing operations, back-office, etc.); and
- Third party processing systems that allowed new small companies to secure many of the scale benefits of the large banks.

Hence, the strategic goals of commercial banks increasingly incorporated specific objectives for computer systems. The new strategic targets aimed to modify the principal-agent transactions between bank and customer because IT applications enabled banks to track relationship profitability for the first time. IT applications allowed banks to focus on profitable customer groups and product markets and also increased banks' abilities to bundle and cross-sell services. As detailed below, this kind of strategic goals was crucial for the success of Lloyds Bank.

2.1.3 Types of Risk Management in Bank Markets

Risk management for banks can be stressed in three different aspects namely, portfolio diversification, integration of financial value added activities, and loan/credit scoring processes (Heffernan, 1996:198; among others). Table 1 summarises the main characteristics of banks' risk management systems and how external change modified these systems. External changes and innovations in banks' risk management systems had distinctive implications for the strategy of banks aiming to maintain a competitive edge. The effects of external innovation can be summarised as how external change modified international portfolio diversification, the combination of technology with advances in Financial Theory and thirdly, how non-economic factors could explain lags or geographic differences in the adoption of technological and risk management innovations.

[Insert table 1 around here]

The effect of external change on international portfolio diversification was that bank managers found an attractive way to retain fees from managing international lending but pass on the balance-sheet exposure to other banks. However, new and inexperienced intermediaries became part of these transactions. In other words, bank disintermediation and the globalisation of financial markets substituted market-based transactions with risk previously priced through banks in-house risk management systems. The result of this trend was that bank managers had to develop new capabilities and organisational skills for banks to maintain a competitive edge.

Secondly, the combination of technology with advances in Financial Theory (such as wider applications of CAPM or models to price derivative products) intermediaries were able to increase banks' product and product/market portfolio by offering new products and services (which emerged from "unbundling", "securitisation", "repackaging" and "segmentation"). Initially most of these innovations took place in the corporate side of the business because larger firms had more financial capital than retail customers did (Fraser et al., 1995:19; and Heffernan, 1996:199 among others). As costs fell banks were able to extend many of the same procedures into retail markets so that securitisation of mortgages, credit card receivables or "index" products became common. As a result, participants in bank markets became more interest-sensitive on their funding needs and adopted more sophisticated cash-management techniques (Gardener-Molyneux, 1990:93). However, at the end of the 1980s and in the 1990s deposit-taking remained the most important factor in maintaining an established customer base in retail banking (op. cit.).

Thirdly, non-economic factors such as changes unique to the geographical, social or political forces surrounding bank markets could explain lags or geographic differences in the adoption of risk management innovations (Fraser et al., 1995:450). In the research which follows, the inquiry will explore whether those lags in the adoption of innovations were linked to competitive factors. For example, some banks could have considered that innovations in international markets and new products threatened their on-going business. Innovations in risk assessment techniques together with those in telecommunications required new capabilities and organisational skills that many banks were not willing (or able) to develop. Hence, collusion agreements could explain differences in the introduction and adoption of innovations (as originally proposed by Bain, 1950:37). In the case of bank

markets, technical and risk management innovations would be reflected in the development of new skills to cope with mark-to-market capital management, new distribution systems and new instruments that brought greater transparency and volatility to both sides of banks' balance-sheet.

3 THE LLOYDS BANK GROUP

3.1 Origins and Growth

3.1.1 Establishment

Lloyds Bank opened for business in June 1765 at Birmingham as Taylors and Lloyds, and remained a private firm (single branch bank) until the middle of the 19th century[1]. Taking advantage of the amalgamation process that then swept British banking, Lloyds began to expand throughout the Midlands and by 1923 acquisitions and mergers had provided it with offices across England and Wales. This growth is summarised in table 2 and shows how by the mid-1970s Lloyds Bank was one of the four major domestic banks in the UK (albeit the weakest of the four) and a significant international player.

[Insert table 2 around here]

Lloyds Bank International grew to be the subsidiary responsible for the international and foreign banking business of the Lloyds Bank Group along with the retail operations of the National Bank of New Zealand (purchased in 1966) and Lloyds Bank California (purchased in 1974). The international banking business of the Lloyds Bank Group overcame the shortfall in local deposits by borrowing heavily from the Eurocurrency market to supply corporate and sovereign lending in Europe, North and Latin America (especially in Argentina, Brazil and Mexico). By the end of the 1970s the business of Lloyds Bank Group could be regarded as traditional banking business in domestic and international lending and deposit taking; as well as in domestic and international payments.

3.1.2 Response to Environmental Change

By 1980 the Lloyds Group had a world-wide branch structure and business was conducted through 2,349 branches in the British Isles and 498 abroad. The network included Europe, North and South America, as well as Australia, New Zealand and the Far East. The foreign expansion of Lloyds peaked in 1984 with operations in 47 countries. Despite this international growth, 46% of total assets remained in the UK and, on balance, the domestic assets were more profitable with domestic profits accounting for 57% of the total in 1982.

The profitability difference widened sharply as the emergence of the international debt crisis suggested international banks would required heavy provisions and Lloyds Bank Group was strongly identified with the Latin American markets (The Banker, IV-83, p. 8 and Holmes-Green,1986:254). Since then, in a drastic strategic policy change, management led the bank to a de-emphasis of international activities. Lloyds' domestic/international balance changed rapidly through domestic acquisitions and by 1990 domestic assets accounted for 82% of the balance sheet. The result of this strategic change was that in 1992, Lloyds had 1,960 branches in the UK complemented with 316 branches in 15 countries to carry out its business. However, the bank's public position changed alongside the shift in strategic policy and this is clearly illustrated in table 3.

[Insert table 3 around here]

In spite of efforts to grow abroad Lloyds did not have an internationally diversified portfolio since it had been heavily involved in Latin America. The result of the new strategy and the bank's change of public position was that the activities of Lloyds Bank International merged with the parent company in 1986 (more below). The bank began to reorganise itself by business units, foregoing geography as a relevant operational factor, and selectively disposing of its international and domestic businesses. The purpose of the new organisation was to focus on specific market segments in order to maximise shareholder value. The strategic focus concentrated in developing retail banking and insurance as the Group's main activities. Lloyds' strategy appears to have taken two steps. First, redefining geographic scope between 1985 and 1987; and second, reshuffling the business-line portfolio between

1981 and 1990. In what follows the discussion presents further detail on the emergence and implementation of Lloyds' strategy.

3.2 Response to the LDC Debt Crisis

3.2.1 Contextual Setting

In the early 1980s, Lloyds Bank Group was a British clearing bank aiming to become a global bank. However, that strategic intent was somewhat modified by deregulation in Britain together with the less developed country (LDC) debt crisis after 1982. The crisis in LDC debt emerged after the OPEC's oil price increases in 1973-1974 and 1979-1980 and the recessions that followed in OECD economies. The LDC debt crisis was a turning point for British international banking because at the beginning of the crisis and in line with historic experience, provisions for loan losses were very low. Banks hoped that international loan syndicates would minimise individual bank exposure to any one-country defaulting and trusted that market forces would discipline borrowers' behaviour by making defaulting a remote outcome. Overnight, the interruption on debt service made commercial banks (and the international financial system) susceptible to the performance of a number of other in-debt countries with the Latin American area suffering major concentration effects. Suspension of debt serviced increased risks, not only geographically (as Brazil, Argentina and Peru were affected) but also as the performance of sovereign (government) debt transferred to commercial (corporate) exposure.

The LDC crisis had two major effects in bank strategy. First, commercial banks were protected by their regulation to avoid widespread bankruptcies. Central banks and the IMF provided funds to maintain liquidity in international markets. Banks were then able to build up reserves, make proper provisions, re-schedule loans and, eventually sell these loans through secondary markets. Strict accountability or reluctance to continue lending would have made many institutions technically insolvent.

The second long-term effect of the LDC crisis was that big corporations found themselves with better credit ratings than the banks they had traditionally borrowed from. The gap encouraged companies to borrow directly from markets rather than through traditional intermediaries (a process called "bank disintermediation").

3.2.2 Lloyds' Strategic Response

Another effect of the 1982 debt crisis was that the international business operations of British banks found it difficult to explore opportunities for cross-border lending and project finance based on their own balance-sheet exposure. The debt crisis also increased risk premiums and weakened the profitability of the parent bank. The first to respond was Barclays Bank, the UK's largest, who in 1983 began a two year process that merged its domestic and foreign arms into a single group.

Provisioning of Lloyds Bank Group encompassed not just sovereign exposure but also their mainstream corporate loans which were generally performing (or prevented from performing) because of exchange controls rather than default. As a result, Lloyds Bank International (LBI) looked unprofitable and Lloyds decided to follow Barclays' lead and merge LBI with the parent bank. The union took place at the beginning of 1986. Through the merger, Lloyds managers closed the possibility of a separate international company that increased an already high exposure or made tax shelter benefits unavailable to the Group. Senior managers perceived the merger as:

> "...drawing together the commercial banking operations of the two banks in one enterprise, backed by the full strength of the Group's capital and balance sheet." (Lloyds Bank, Annual Report, 1984).

From this viewpoint, the merger signalled to both regulators and shareholders that protecting the Group's capital base and profitability levels had top priority. Table 4 shows that between 1981 and 1991 Lloyds averaged higher after tax returns on assets than the other big UK banks (respectively, 0.97% to 0.81%) and higher reserves to total assets (respectively, 5.49% to 4.98%). However, the volatility of Lloyds' returns was higher.

[Insert table 4 around here]

Accounting data during the 1983-1990 period suggests that although LDC-debt problems did not affect Lloyds' growth opportunities more than its peers, they nevertheless significantly increased overall risk levels. Specifically, between 1980 and 1992, Lloyds' charges for bad and doubtful debt averaged 1.14% of total assets after provisions while the Big Four averaged 0.93% (between 1985 and 1992) with a standard deviation of 0.74.

Even after the exceptionally large charges of 1987 and 1989 (that is, £1,273 million and £2,108 million sterling respectively) Lloyds' charges as a percentage of total assets were still above average at 0.98 percent.

In summary, the financial performance of Lloyds during the 1980s was in line with North American experiences (as documented by Berger, 1995), which was that banks generally achieve returns on capital equity above the averages of their closest competitors when levels of default risk are higher.

3.2.3 Origins of Independent Stance

Maintaining strong capital levels at Lloyds proved to be a demanding task given that net aggregate exposure of total debt, as percent of shareholder funds, was 134% in 1983. By 1987 it had been reduced to 71% and by 1988 to 57%. In 1987 Citibank unexpectedly announced a write-off on US$ 2 billion of LDC-debt, Lloyds followed suit by providing for £1,273 million sterling of their remaining LDC advances. Unlike Citibank, Lloyds did not write-off (forgave) these loans or sell them at discount. Due to its previous dealings in the region, senior managers:

> "...believed that there were sound opportunities for economic growth in Latin America and, therefore, refused to sell [its] problem country debt at the bottom of the secondary market." (Senior Manager, 24-X-95).

The decision eventually paid off as the in-debt countries began to service their commitments and successful re-scheduling programs came into effect during the late 1980s and early 1990s. As a result, in 1992 and 1993 interest recoveries and provision releases of LDC-debt represented 25% of the Lloyds Bank Group's pre-tax profits (see further BZW,1992; Warburg, 1993; or UBS, 1994).

In spite of the effects of the LDC-debt in its portfolio (as well as its effects over provision charges and capital levels), Lloyds Bank Group continued to pursue commercial interests in the region even after most physical assets and franchises were sold (between 1986 and 1990). In 1986, for instance, after tax profits from Central and South America represent 4.7% of the total. However, the future of these activities within the Lloyds Group was doubtful. By 1990 and after a thorough review of business lines, commercial interests

continued only in Brazil and Argentina, and these were put on sale at the end of 1997 (Sunday Times, 7-IX-97).

4 PORTFOLIO SELECTION

4.1 Consolidation in the UK

4.1.1 Lloyds Response to Structural Changes in British Regulation Policy

Changes in British regulation took place in conjunction with EC Single Market measures and even preceded actions from Brussels or Basle on some occasions. Table 5 illustrates examples of measures to create greater incentives for incumbents and potential entrants to move into retail finance.

[Insert table 5 around here]

In November 1983 Lloyds launched a new strategy as a response to the changes in its competitive environment and, in particular, the LDC-debt crisis and changes in regulation policy in Britain. The then Chairman, Sir Jeremy Morse, announced the retirement of Mr. N. W. Jones and his replacement by Mr. Brian Pitman. Mr. Jones demonstrated professional mobility while the bank followed an international expansionist strategy. Mr. Pitman, who also came from within Lloyds' ranks, continued with the changes initiated by Mr. Jones, and advocated the:

> “...pursuit of preserving a balanced and profitable rate of growth without exposing [Lloyds Bank Group] to unacceptable levels of risk, we aim to strengthen our position in those areas which offer long-term profitable opportunities and redeploy resources away from activities where potential is limited...” and emphasising fee-earning services to offset declining interest margins. (Lloyds Bank, Annual Report, 1983).

Under the Morse-Pitman management team Lloyds was reorganised into business units, abandoned geography as a relevant operational character, underwent a thorough cost-cutting exercise and emphasised service quality as well as share-holder value. The strategy sought:

- To equalise an imbalance (between sterling deposits and dollar-denominated assets in light of the LDC-debt crisis).
- To take advantage of new opportunities in retail finance (emerging from deregulation in Britain).

The strategic purpose of the new organisation was focusing on specific market segments in order to maximise shareholder value. Figure 1 illustrates this shift into core markets through acquisition and divestitures by grading business-lines according to geography.

[Insert figure 1 around here]

In the scale, "1" represents regional business; "2" nation wide services; "3" servicing more than two countries; "4" represents a separate division for operations in the home country; and "5" growth of the bank throughout two or more trading blocks (Asia-Pacific, Nafta or EU). The figure also depicts Lloyds' acquisition and divestiture strategy as the length of each line represents whether a business line was part of the business portfolio for a specific year.

The graph in figure one depicts several dimensions of Lloyds' business portfolio "converging" to level 2, that is, operations at nation wide scale. Among others Channon (1988:36) and Gardener-Molyneux (1990:52), expected that banks increased their geographic scope as a response to regulatory change lowering entry barriers to several bank markets (such as the Single Market in Financial Services). However, changes in Lloyds' business portfolio suggest that the most promising opportunities were found in national domestic markets. Lloyds' response was not unique as eventually other mayor players in UK markets developed similar patterns and concentrated their portfolio of activities in their indigenous markets. A move that was made by other players in spite of their initial cross-border investments to capture opportunities linked to changes in the competitiveness of Western European and North American bank markets (more below).

4.1.2 Trimming the Business Portfolio

The strategic change of Lloyds gave a new dimension to the bank in terms of its product market and geographic scope. The move to modify the business portfolio was deemed necessary in order to meet a shareholder value requirement equal to 18% after tax ROE (Senior Manager, 3-III-95 and Bose-Morgan, 1998:99). In the pursuit of maximum shareholder value, most of Lloyds foreign branch operations were divested by 1986. These included the franchises in Canada (acquired in 1986) and the US (California in 1986 with other minor holdings held until 1990).

The North American divestitures proved to be a major problem for Lloyds in the UK recession of 1989-1993 when competitors were able to rely on significant cash-flows from US operations. Barclays, NatWest, Midland and The Royal Bank of Scotland (through Citizens Bank) received substantial positive cash inflow from abroad while the local demand picked-up and bad loans were subdued (Financial Times, 29-XII-92). As a result, during the early 1990's Lloyds' stock market performance was below that of its main competitors (more below).

4.2 Mergers and Major Acquisitions

4.2.1 Bid for Standard Chartered Bank

Lloyds' acquisition and divestiture strategy sat alongside a policy of internal investment. Acquisitions, therefore, followed careful analysis by small in-house teams designed to spearhead entry into target market segments. One exception to this philosophy came in 1986 when Lloyds (by then on a high stock market value), used its stock market rating to make an unsolicited if not hostile US$1.94 billion dollar bid for Standard Chartered Bank (a UK regulated bank with most of its business in ex-colonial localities like Africa, Asia and Middle East). Lloyds justified the bid as a way to consolidate its international position and build an international bank with firm roots in key international locations. Senior managers at Lloyds described the strategy as giving Standard Chartered:

> "A home base to its international retail operations." (Senior Manager, 17-II-95).

Under this scenario Lloyds stock market standing provided it with an "option" to build international banking through acquisition. In the aftermath, this was not the case as Lloyds'

bid was rejected in favour of a “white knight” defence in which substantial holdings of Standard Chartered passed to two Asian and one Australian businessmen. Meanwhile, Lloyds' Chairman and CEO, as instigators of this opportunistic bid, regretted the decision from Standard's board (Lloyds Bank, Annual Report, 1986 and The Banker, VI-86, p.10).

4.2.2 Purchase of German Bank

Standard Chartered's rejection undermined any continued credibility of Lloyds as a major international bank and emphasised Lloyds' focus on domestic and non-traditional banking services. Lloyds international ambitions were then restructured to develop a private bank (called Schröder Münchmeyer Hengst).

The strategy was based on exploiting the bank's historical commercial links through its branch network with high net-worth individuals in South America and elsewhere. The strategy, therefore, identified an international business line that was fee based and hence required little in the way of capital or branch support. In the pursuit of this strategy, Lloyds took an interest in the German private bank named Schröder Münchmeyer Hengst. An early interest was taken in 1983 and converted into a holding of 91% of the capital in 1985. Full private banking activities developed by 1988 but they barely unfolded as a source of income since they contributed only 2.5% of Lloyds pre-tax profits in both 1992 and 1993. As a result of continued under-performance, the German bank was sold in 1996.

4.2.3 Investment Banking

A distinctive feature of Lloyds specialisation program took place in 1986-1987. At that time the Bank of England introduced a package of securities market reform (the so-called “Big Bang”) which abolished fixed broker commissions and ended the separate roles of brokers (sales offices) and jobbers (market makers). As a response to the “Big Bang”, leading Continental and American banks bought into the City hoping to gain on the government's privatisation drive.

As for clearing banks, one of Lloyds competitors (Barclays) spent over 100 million sterling to purchase a stock broker (de Zoete and Bevan) and two jobbers (Wedd and Durlacher), in an aggressive move into merchant banking (Channon, 1988:219). Barclays eventually made the organisational adjustments required to accommodate merchant and

clearing bank cultures. Although a marginally profitable operation emerged, returns were not commensurable with the risks and Barclays de Zoete Wedd was broken up for disposal in 1997. Another big UK bank (NatWest) grew organically to create NatWest Markets. This too was broken up late in 1997 for piecemeal disposal. The other clearing banks lacked the balance-sheet size to compete in investment banking but even so, presented themselves as merchant banks.

Lloyds pursued a different course. The merchant banking venture, initiated in 1984-1985, was formally closed in 1987 (some minor activities remained but they were eventually shut-down. See Financial Times, 20-X-92.) Senior managers said that:

> "Rather than a problem of size the closure was made in order to continue with the specialisation program started in 1983." (Senior Manager, 24-X-95).

The exit from merchant banking released capital for other UK-based activities where the bank had existing or potential capabilities such as real estate, private banking, corporate finance and insurance (more below). Lloyds' management considered that in the medium and long-term, merchant banking would produce a ROE below the minimum they required. Nevertheless, the closure meant Lloyds' capabilities to compete in the fast growing securities market disappeared.

4.3 The Provision of Bankassurance

4.3.1 The Search for Reductions in Cost of Capital

A major and innovative characteristic of Lloyds' acquisition and divestiture strategy was the development of bankassurance. The strategy started after the failed bid for Standard Chartered Bank. Lloyds Bank Group became the first British clearing bank to develop allfinanz with the 1988 purchase of Abbey Life (a dynamic, direct sales, life insurance company) and its financial consolidation with Black Horse Life Assurance. Rumours of the merger with Abbey Life had been circulating in the City for several months, but most observers were still taken aback by the scale of the deal. Lloyds received 57.6% of the enlarged Abbey in exchange for management control of 5 former subsidiaries (life assurance, estate agencies, insurance brokers, a finance house, as well as a unit trust and off-shore

funds manager). Without issuing debt or share capital (while other banks were actively doing so), Lloyds' managers were able to:

- Acquire control of the second biggest British life insurance company;
- Increase insurance-related earnings from 3% to 30% of total after-tax profits; and
- Effectively value subsidiaries worth £400 million sterling in the balance-sheet at £1.15 billion (or the market value of 57.6% of Abbey's shares).

Financial results emerged from clever engineering by Lloyds' managers as they got Abbey Life to buy assets from Black Horse Life and thus, generate a profit so increasing the asset to value of Abbey Life and reduce the write-off of good will. For legal reasons Abbey's 3,200 strong sales force was to be kept separate from Lloyds' 6 million customers. But Abbey's managers were given the mandate to improve the performance of Black Horse Life (which was to continue getting referrals from the bank's branches) and Lloyds Bank Insurance Services (an insurance broker).

Lloyds' management justified the expansion into life assurance arguing that:

> "Europe is fully banked so insurance provides better opportunities for greater penetration..." particularly in "underinsured" countries such as Spain and Italy. (Lloyds Bank, Annual Report, 1988).

For Lloyds' managers, the insurance markets of some European countries in which they traditionally had presence seemed to have a high potential for growth after the beginning of the Single Market in Financial Services (which was by then only 4 years away). Bankassurance was expected to augment the creation of shareholder value by both maximising established distribution channels and increasing non-interest related income.

4.3.2 The Pursuit of Synergy

Synergy constituted a major potential source of sustainable advantage for Lloyds Abbey Life. The strategic challenge for the executives of Lloyds Abbey Life was to double

Black Horse Life's sales force to 800 staff in order to capitalise on market research which showed that:

> "...as many as 79% of the bank's customers would positively welcome Lloyds' own [insurance] products." (Banking World, 1-VIII-89, p. 19).

At the time, Lloyds Abbey Life was the only retail finance intermediary acting as the direct sale force for a bank with the addition of a real estate agency of more than 500 outlets[2]. After the 1988 deal, success for Lloyds Abbey Life executives would come not only from managing this network, but from developing referrals for mortgages and related insurance. Synergies were then expected to be created for the Lloyds Group as a whole and to act as a barrier against building societies' intent on entering into "traditional" banking markets.

4.3.3 Weight in Business Portfolio

As a result of the Abbey Life acquisition, insurance was second only to retail banking as a proportion of after-tax profits. Early success was attributed to Michael Hepher (chairman of Abbey Life). This success made him heir apparent for the Lloyds Group but the momentum was not sustained. Insurance contributions to the Group's overall earnings started to decline and by 1992-1993 net earnings grew less than 10% per annum because of modest asset growth and lower investment income (Société Genérale, 1995). Financial performance not only reflected expected synergies failing to materialise, but also how Lloyds' insurance business grew to 912 million sterling in 1992 as compared with other competitors such as Barclays increasing its operation (to 1,940 million sterling in assets). In other words, absent from Lloyds' growth was cross-selling opportunities, net fee income and investment returns of insurance assets.

Despite the disappointment in bankassurance, the success of Lloyds in improving overall profitability, achieving major cost savings and rationalising activities made Lloyds the strategic icon of British banks in the early 1990s. Lloyds was clearly the most profitable UK clearing bank and the only British bank to score within the top 50 of IBCA's 1992 Bank World Ranking (Financial Times, 4-XI-92).

5 THE END OF AN ERA

5.1 Last Strategic Stance

5.1.1 Lost Opportunity for Expansion

At the end of the 1980's, Midland Bank, a long-standing rival and once the largest bank in the world, was headed for failure. For some time the Bank of England had been looking for a solution from the other major UK banks. Other major clearing banks, in turn, refused on the grounds that "the British banking sector was overcapitalised" (Senior Manager, 17-II-95), that is, other banks refused taking over Midland by arguing that external change had left them with excess operating costs. Therefore, Midland's potential bankruptcy would increase business volume for other clearing banks.

In 1992, though, a bid did materialise from the Hong Kong and Shanghai Banking Corporation (HSBC) who, with an eye to Hong Kong's power transfer in 1997, was seeking a UK base. Managers from HSBC were already acquainted with Midland's management and operations and controlled 14.9% of its capital (the latter resulting from a private placement in 1987). Due diligence procedures were initiated when Lloyds made a counter bid for Midland, basing its claim on its credibility as the best performing UK bank.

Lloyds argued that it could apply recognised rationalisation expertise to transform Midland's operations (Stonham, 1993:9-10). Lloyds proposed using Midland's unique and successful network of 16 regional processing centres to remove back-office activities from its own retail branches. Midland's branch network and offices could remedy some of Lloyds' long-standing weaknesses in its regional presence especially in the North of England. Midland also offered an attractive customer base where bankassurance could grow and the innovative telephone banking subsidiary offered potential (First Direct, established in 1989).

Lloyds' bid was unsuccessful because of the previous arrangement between Midland's management and the HSBC as well as the environment created by a threatened referral to the Mergers and Monopolies Commission. The victory of the HSBC bid reversed the decline of a major Lloyds' competitor, strengthening one of the weakest players in the marketplace and increased pressure on other incumbents to pursue greater rationalisation and cost-cutting.

5.1.2 Death of the Global Bank

The balance of Lloyds' acquisition and divestiture strategy after the failed bid for Midland bank, brought about the end of the era when the growth of banks' assets was the accepted benchmark for success. Through the move, Lloyds' Board responded to rapid marketplace change and the challenges of new competition from traditional and new entrants, by evaluating strategic options against a common benchmark of ROE. The 18% ROE target reconfirmed the attractiveness of off-balance-sheet services. Simultaneously, the higher costs of geographical distribution converged international operations into the home-base (i.e. the UK and, to a lesser extent, New Zealand). Senior managers argued that:

> "Planting banners in a country was not enough to succeed and profit from international banking." (Senior Manager, 3-III-95).

Indeed, with improved telecommunications and more competitive correspondent agreements international banking no longer depended on a large physical presence in a country. Lloyds could therefore streamline its international operations to fit the Group's return requirements.

5.2 Stock Market Performance

5.2.1 Event-Study

The rationale behind Lloyds' strategy throughout the 1980s was that shareholder value is created if the bank's strategic performance translates into stock returns over and above those averaged by the bank's main competitors. Otherwise, stock owners have an incentive to patronise a competitor or migrate to other investment alternatives. Lloyds strategy marked the first time that a bank introduced shareholder value as a distinctive view of performance at the time when most competitors managed efficiency by way of accounting ratios. Shareholder value creation represented a strategy that enabled the Lloyds Bank Group to outperform its peers in the stock market between June of 1985 and October of 1992.

Over performance is illustrated in figure 2 as the reversal of a negative trend in cumulative abnormal returns (CAR) that began in late 1982 (see further appendix). The change in trend not only brings CAR back to zero but continues to its peak in October of

1992, that is, until after the failed bid for Midland Bank. Key events in Lloyds' diversification policy coincide with the CAR line crossing the zero value, for example, the consolidation of LBI and the parent bank in 1986 or the purchase of Abbey Life in 1988.

[Insert figure 2 around here]

5.2.2 Steep Decline

Lloyds pursued a distinctive and successful strategy between the second half of the 1980s and the recession of 1989 to 1992. But what explained the steep and steady decline in returns after the second half of 1992? There seem to be five partial explanations for this shortfall, namely accounting performance, economic recession, change in the line of command, improved performance of main competitors and changes in accounting standards. All these are summarised in table 6.

[Insert table 6 around here]

Five factors that modified the perception of Lloyds being the most successful UK bank. One source of concern was the economic recession and associated loss of real estate values that characterised Britain in the early 1990s. This resulted in negative prospects of short-term asset growth for Lloyds with no end to the recession in the UK property market in sight (Financial Times, 8-IX-92). The prolonged slide in the residential and commercial real estate markets continued to produce high profile problems such as Canary Wharf and high rates of non-performing private loans and mortgages. Lloyds' loan collateral in the small business sector continued to lose value while the real estate agency business was stagnant and related growth in loan-loss provisions continued. As the effects of bad debts in the early 1990s started to unwind, Lloyds' senior managers began to realise that:

> "Retail [banking] specialisation also has its downside..." but above all, that one of the big mistakes in the last decade was "...underestimating the length of the UK recession and its impact on the real estate market." (Senior Manager, 3-III-95).

The reality was that asset value adjustment was not confined to the UK but was a general problem generating from the earlier deregulation of exchange and money markets. Moreover, Lloyds' fall in operating income implied that the group would depend on insurance and LDC-debt management for cash-flow. This placed Lloyds at a disadvantage when compared with competitors because other major UK clearing banks such as Barclays, NatWest, Midland and The Royal Bank of Scotland benefited from their profitable operations in the US. Positive cash-flow expectations for these stocks operated against Lloyds' relative stock market position (Financial Times, 29-XII-92) and, hence, the drastic fall in CAR values.

5.2.3 External Change and After Tax Profits of Major UK Banks

A noteworthy feature of the stock market assessment was that during the 1980 to 1992 period after tax profit of the top four British banks was £252.9 million pounds and decreased 57.1% on average (as profit after tax figures show in table 7). The downward trend of inflation-free, after-tax profits of the UK clearing banks reflects unprecedented external changes that during the 1980s diminished earnings growth for banks in Western Europe (Gardener-Molyneux, 1990:81 and Channon, 1988:117). Changes in banks' balance-sheet could have source in increased competition, the introduction of capital constrains or increased growth and depth of new financial markets. However, the downward trend could also have responded to individual asset and liability management.

[Insert table 7 around here]

Table 7 shows that Lloyds' real annual net benefit was equal to £251.8 million sterling and the average rate of growth was -80.6% for the 1982 to 1992 period. Excluding the exceptionable charges for LDC debt in 1987 and 1989, Lloyds' real annual net benefit equalled £371.92 million and the average growth rate was -0.28% for the 1982 to 1992 period, that is, the third highest real average net benefit of the top UK clearing banks. Deflated financial results suggest that Lloyds' above average financial performance resulted from managers' efforts directed to a strategy that maintained profitability (i.e. creating shareholder value and stock market position) rather than asset growth. However, poor

financial performance at the beginning of the 1990s together with several years of cost-cutting and downswing, placed suspicion in the management team that:

> "Some people inside thought that [Lloyds'] critical mass went down too much." (Senior Manager, 17-II-95).

Shortly after Lloyds group continued with the diversification strategy by strengthening its product market position in Britain. The move was made through the 1995 acquisition of a cost-efficient mortgage provider (Cheltenham & Gloucester Building Society) and the 1996 merger with another bank (TSB Group) which had greater focus than Lloyds in customer segments seeking low cost financial services (see further Collett-Maher, 1997 or Bose-Morgan, 1998). Lloyds was then in a position to overcome other major UK banks in terms of assets and profitability (Collett-Maher, 1997:20).

6 DISCUSSION

The strategy of Lloyds Bank Group characterised by the withdrawal from several locations, the consolidation of business lines, emphasis on cost reduction schemes and retail banking specialisation. Lloyds Bank established a dominant position in Britain because its managers made a careful selection of the markets where the bank was to compete but it is obscure whether geographic divestitures and product and customer group diversification followed visionary or tactical strategies.

Lloyds' acquisition and divestiture strategies during the 1980s responded to changes in its external growth opportunities emerging from the LDC-debts crisis and deregulation in Britain. Lloyds' approach allowed it to compete in market segments not serviced by other clearing banks or the building societies. In particular, Lloyds was the first to develop a major bankassurance operation in the UK as well as being the first financial institution to develop a national real-estate agency network to capture mortgages and other financial service references.

Lloyds' specialisation strategy built upon management emphasising value creation, profitability rather than growth per se (following a very stiff criterion equal to 18% ROE), and the pursuit of complementary business-lines. Financial control targets (or an 18% ROE) resulted in Lloyds' abnormal returns relative to its sector outperforming the closest

competitors between June 1985 and October 1992 (see appendix). But specialisation and rationalisation also had its down side. At the end of 1992 Lloyds' income was highly dependent on the proceeds from a single currency and geography while the attempts at fee-income generation were innovative but not as profitable as initially expected. Therefore, rather that visionary strategies anticipating high competitive advantage, Lloyds acquisition and divestiture policy suggests the importance of execution skills to capture promising growth opportunities, that is, resource flexibility is a key condition to achieve competitive advantage for those banks following tactical moves.

In brief, to achieve long-term success Lloyds' strategy built upon the belief that customers would remain loyal and would respond positively to business line growth. The strategy was innovative for the UK environment and assumed active control of the banks' core capabilities through financial control parameters. However, at the end of the 1980s the durability of Lloyds' approach to competitive advantage was put into question by the short-termism that predominated in the stock market.

7 APPENDIX: EVENT STUDY FOR THE LONG TERM STRATEGY OF LLOYDS BANK GROUP (1980-1993)

7.1 Methodology

This section presents an alternative study of bank efficiency to that of accounting ratios. The goal is to establish the performance of Lloyds Bank Group in the stock market and whether (and when) Lloyds outperformed its peers. This study analyses the bank as a single, combined entity and uses stock market returns. Abnormal returns are defined on an industry relative basis, in terms of the difference between Lloyds'- and banking-industry returns. As with other market adjusted analysis, the aim is to capture stock price variance not explained by overall market performance (for a brief review see Pereira, 1997. For the statistical properties of the methodology see Brown-Warner, 1980). Formally,

$$R_t = \alpha_0 + \beta_1 R_{mt} + \beta_2 D_t + e_t \quad (1$$

$$AR_t = R_t - (\alpha_i + \beta_i R_{mt} + \beta_2 D_t) \quad (2$$

$$CAR = \Sigma AR_t \quad (3$$

where

R_t	Return of bank.
R_{mt}	Return on the Banking Sector Index.
D_t	Instrumental ("dummy") variable:
	D = 1 for 1985.06 to 1992.10,
	D = 0 elsewhere.
AR_t	Above normal returns.
CAR	Cumulative sum of abnormal returns.

Estimating equation 1 through ordinary least squares (OLS), the instrumental variable (D_t) aims to pin-point how Lloyds changed strategically and whether there was a breakout in stock market returns at strategically important periods. In this way statistical significance reinforces the validity of qualitative analysis. However, valid inference for CAR can only be reached where residuals (e_t) are free of autocorrelation and heteroscedasticity, that is, their expected value must have a mean of zero and constant variance. Autocorrelation was tested

according to the procedures specified by Durbin-Watson, Box-Pierce and Ljung-Box; while White's test examined the presence of heteroscedasticity (procedures fully documented in Raymond-Uriel, 1987). As suggested by Leamer (1985), regression estimates should be followed by a sensitivity analysis. For that type of analysis Morgan-Morgan (1987) and Kryzanoswki-Zhang (1993) suggested using Engel's (1982) autoregressive conditional heteroscedasticity (ARCH) model. Specifically:

$$R_t = \gamma_0 + (\gamma_1 + \gamma_2 D_t)R_{mt} + \gamma_3 D_t + \theta h^{0.5}_t + \varepsilon_t \quad (4$$

and

$$h_t = \alpha_0 + \delta_0 D_t + \Sigma\, \alpha_i \varepsilon^2_{t-i} \quad (5$$

where

ε_t Normally distributed error term with mean 0 and variance h_t.

Besides testing for the stability of regression coefficients, non-parametric tests can help to assure that regression residuals meet OLS properties (see Brown-Warner, 1980 and Zivney-Thompson, 1989). Two such tests are the Sign test and Wilcoxon rank test (as specified in Mansfield, 1987:370-6).

7.2 Data Sources

Price data for Lloyds Bank Group and the FT-Bank index were obtained from DataStream as monthly averages, between January of 1980 and December of 1993, 168 observations were available for stock market prices. Prices were then transformed into real returns by deflating with the retail price index (where 1987 = 100), and these deflated monthly averages turned into estimates of real annual rates of growth for both Lloyds Bank Group and the FT-Bank index. The analysis of deflated values was then in a stronger position to assess the (long–term) strategy of Lloyds Bank Group and its stock market performance than using nominal stock prices or the market value of the stock (see further Brown-Warner, 1985). This position was achieved because inflation-free stock returns had a smaller long-term variance and the added value of diminishing the effects from changes in the capital base or dividend payments. The white spaces in figure 3 suggest that Lloyds' deflated stock prices over-perform the annual real change in the bank index.

[Insert figure 3 around here]

Visual examination of the difference in performance suggests Lloyds delivering superior returns in more than one occasion and particularly between June 1981 and August 1982. After that the association of Lloyds with Latin America seems to have reduced its stock market performance until April 1983. Later on and with the exception of the first semester of 1988 and the second semester on 1990, Lloyds' stock market returns seem to over-perform the banking index from mid-1985 to January 1993. The beginning of this period coincided with the start of Lloyds' international divestitures (January 1985 to December 1987), the provisioning for LDC-debt (June 1985), the purchase of a German bank (1985-1996), and the investment banking adventure (1985-1987). At the same time, the end of the period coincides with Lloyds' failed bid for Midland Bank and a smaller than expected dividend payment.

In what follows the analysis considers whether the stock market performance of Lloyds Bank consistently outperformed the FT Bank index between 1985 and 1993.

7.3 Empirical Results

Table 8 shows the correlation matrix for the variables so far discussed (where STOCK is Lloyds' stock price, FTBANK the index, the prefix "D" signals deflated variables and the prefix "C" real annual changes). The greatest degree of correlation is observed for nominal values (0.97), but real annual changes do not lag very far behind (0.83). Any of them is more than the threshold value of 0.254 for a 99% level of significance. At the same time, covariance between nominal returns (10312.66) is significantly greater than amongst real values (0.033).

[Insert table 8 around here]

These real annual rates of growth were substituted in equation 1. Initially, they observed first order serial autocorrelation [represented by AR(1)]. The non-statistically-significant intercept (α_0) was dropped, and autocorrelation taken care of through an first difference of

error process [AR(1)]. However, before and after those corrections White's test strongly suggested the presence of heteroscedasticity. Following Kritzman (1994) the instrumental variable (D_t) was substituted with an alternative specification. This divided the sample into three equal size sub-samples (1981.01 to 1985.04; 1985.04 to 1989.08; and 1989.09 to 1993.12). As expected in all counts the intercept (α_0) lacked statistical significance. White's test rejected the null hypothesis of homoscedasticity both before and after omitting the non-statistically-significant intercept and after the first order autoregressive process.

Data series were then transformed using natural logarithms of real annual rates of growth. This data was also corrected for first degree autocorrelation. Graphical inspection of its residuals suggested that both autocorrelation and heteroscedasticity were dealt with. Results of Ljung-Box and White tests agreed with casual observation.

As equation 6 shows, under the logarithmic specification the elasticity coefficient for the instrumental variable (β_2) was significant and had a positive sign (where the parenthesis show standard errors, all significant at the 95% level, and the adjusted $R^2 = 0.919$). In brief, statistical evidence suggests that Lloyds financially outperformed its peers for a sustained period of time (i.e. between June 1985 and October 1992).

$$LN(R_t) = \underset{(0.041)}{1.083}\, R_{mt} + \underset{(0.027)}{0.065}\, D_t + \underset{(0.044)}{0.859}\, AR(1) + u_t \qquad (6$$

where

$AR(1) = e_{t-1} - e_t$

e_t Residual from the regression with autocorrelation.

The nature of OLS estimates was further corroborated by sensitivity analysis. However, the four lag ARCH model (without intercept)[3] could not overcome the autocorrelation and heteroscedasticity problems. Such statistical behaviour is consistent with that reported by Morgan-Morgan (1987). Finally, non-parametric test confirmed that the residuals from the logarithmic estimation behave as a normal distribution (as required by OLS). The Wilcoxon rank test indicated a 35% probability that Event and non-Event residuals belonged to the same distribution, that is, the behaviour of CAR (equation 3) between June of 1985 and October of 1992 reflected the strategy that enabled the Lloyds Bank Group to outperforms its peers in the second half of the 1980s.

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NOTES

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[1] This subsection borrows freely from unnamed documents supplied by the Archive Section of Lloyds Bank Group (currently Lloyds TSB Group). It also benefited from lengthy discussions with senior executives of the bank. See further Winton (1982).

[2] Estate agencies were physically separate and independently run from Lloyds' retail banking branches. Estate agencies had been acquired from 1975 onwards but major acquisitions in 1982 made Lloyds' Black Horse Agencies one of the five biggest estate agent chains in Britain.

[3] The number of lags was selected according to Ljung-Box after fist order autocorrelation was corrected (for the latter see Engle 1982:989). An ARCH with 12 lags and no intercept reported the same behaviour as the one recorded in the text. This model is not shown for brevity but was subjected to the same residual properties and non-parametric tests (as was the case of the equal-size instrumental-variable models.)