Banking Strategies and Beyond 2000

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Table of Contents

Foreword . . . . *v*
1 The competitive landscape 1
The changing financial services market—the backdrop to acquiring IT solutions. 1
Case Study 1: Bank of America 2
Competition - centralization of delivery 5
Delivering financial services through partnership 11
IT and partnerships key to future survival 14
Case Study 2: la Caixa. 20
2 A new technological framework **23**
A brief history of computer/business architectures 24
The weaknesses of the legacy IT architectures 30
The 3rd generation—the Internet Computer Architecture 39
Case Study 3: Westpac - replacing old infrastructure with new . . . 42
Case Study 4: CERA Bank Belgium 47
Case Study 5: Nomura—a strategy for approaching the Network Age architecture. 48
Case Study 6: Toronto Dominion Bank 50
3 Knowledge and financial services **53**
Knowledge as a factor of production. 53
Competing with knowledge. 57
Data vs. information vs. knowledge 57
Case Study 7: Global data warehousing - Citibank. 63
Competing with knowledge. 64
Knowledge battleground—the problems established firms have found in using knowledge to compete. 67
Delivering knowledge. 71
The integration, quality and cleansing nightmare. 74

The knowledge battle ground in the era of the Internet Computer Architecture 75

4 Technology and the globalization of retail finance 79

Internationalization of retail financial services and the reform of high-net-worth banking 79

Factors working against overseas expansion 80

Drivers to increased cross-border activity 82

Technology and overseas expansion - the key to accessing new markets and driving down entry costs 86

Private banking—an established global retail market place that is increasingly driven by technology 93

Case Study 8: Wachovia Corporation, USA 95

Global virtual private banking 100

Case Study 9: UBS—cutting the cost of accessing custodial services 108

5 Enabling merger - the role of technology 111

IT costs—first up then down following merger 113

Case Study 10: Lloyds TSB Group—merger complexity in the non-network age IT environment 113

Overall cost reductions—technology is the enabler 115

Using IT to increase revenues from the merged customer base 116

The issue of speed—the key to the success of a merger and the weakness of legacy technologies 117

The Network Age architecture in implementing merger 125

Case Study 11: Halifax—Business change—the Halifax experience 127

6 Banking in the e.era 131

Part 1— Where do banks fit into the Internet age? 131

Part 2—The delivery of financial services in an age of a computer in every home 133

Part 3—The role of banks in supporting e-commerce 142

Internet payments and trust 144

Case Study 12: Smart Cards and the Internet—new service opportunities 148

Competing in the Network Age—an overview 154

Conclusion 157

Index 165

Foreword

The spread of network and Internet technology is radically altering every aspect of the business world—and nowhere more so than in the financial services sector. The progressive breakdown of traditional divides between institutions is accelerating, and the boundaries of the sector itself are becoming increasingly blurred. Already, through the advent of the Internet and associated technologies such as interactive television, it is perfectly possible to envisage a time in the not-too-distant future when banking services will be directly accessible from every living room and office in the Western world.

The implications of such sweeping change are profound in the extreme, and it is imperative that financial institutions evolve appropriate responses to the challenge of this new order. Fleet-footed new competitors, unfettered by the legacy of systems and methods of the more established institutions, and free of any perceived need to offer a comprehensive range of services and products, are constantly appearing. They offer precisely targeted and highly innovative services that directly exploit these new low-cost delivery channels.

To defend themselves against this sniping, established institutions have to become fully capable of operating and *winning* in this demanding new environment. This can only be achieved by adding flexibility and speed of response to their more traditional strengths, thereby enabling them to provide their customers with a range of services which are at least as innovative as those offered by the new niche players, without sacrificing the universality that still remains their greatest asset.

To achieve this, the ability—and willingness - to treat the customer as a genuine partner in a valued relationship is crucial.

Valuing customers means dealing with them intelligently. In short, we have to start acting smarter—whether in targeting products, in dealing with enquiries through call centers, in face-to-face meetings at branches, or in maintaining a dialogue with them via the computer, television or mobile phone. In such circumstances, delivery, customer knowledge and customer management are inextricably bound together and all are being radically affected by the march of technology.

As a consequence, technology increasingly impacts all our strategic decisions, from customer service and sales to mergers and acquisition and asset allocation.

Personally, I have no doubt that we will continue to prosper in this challenging new environment, through the intelligent use of new technologies. And since the first two ingredients of success are knowledge and understanding, I commend *Banking Strategies and Beyond 2000* to you.

Mike Blackburn
President of The Chartered Institute of Bankers

Chapter 1
The Competitive Landscape

The changing financial services market—the backdrop to acquiring IT solutions

The purpose of this book is to look forward at the challenges and opportunities created for the financial services sector by the increasing use of standards-based information systems and networks. Its aim is to look at financial industry strategies in the light of new technologies, rather than at the technologies themselves. It raises such issues as how new methods of delivering financial services will impact on the relationship between customer and financial service provider. In essence it tries to outline how the new technologies, such as the advances in customer relationship management systems and new delivery channels—for example, the Internet and interactive television—will change the structure of the industry.

Although many financial services firms are recognizing the need to create and keep up with changes in the delivery of financial products, they do not necessarily have a wider view of how such changes need to be supported by advanced customer management and knowledge technology. They also may not see its impact on areas such as mergers and acquisition strategies and new competitive environments in globalized markets. As will be seen throughout this work, technology and business strategies in the financial services sector are now inseparably linked.

Change is a word that many do not easily associate with the financial services industry, especially the retail financial sector. In the past new technology may have been viewed as a threat by many in the financial sector because it represented change. Yet, in reality change is no stranger to this industry—no less so than any other. Banking and finance is a very old industry and its basic function of storing and transferring value is still the same. However, today the way in which banks and financial institutions create value for their customers is becoming much more complex as customers themselves become more financially sophisticated and demand more advanced products.

Fifty years ago, people would have been amazed that it is now possible go to a cash machine anywhere in the world and use a plastic card to get cash in the local currency. Likewise, the concept that a trader in Zurich can trade shares in Hong Kong from the comfort of his desk by pressing the keys on a keyboard would equally have been science fiction.

These revolutionary changes in the way value can be transferred have also been reflected in the storage and creation of value. Indeed there has been, arguably, greater change in the realm of value storage and accumulation. The dimensions of this function have changed dramatically. The storage of value can also be interpreted as the protection and accumulation of future value. The development of futures and options and complex hedging instruments allow firms, and indeed individuals, to protect themselves against future impacts on the core value of their funds.

The pace of change is undoubtedly picking up, but it has been a continuing feature of financial services. Many changes have been directly related to the development of new technology. However, the financial services industry is not simply reactive to the development of technology; it can itself lead change and encourage technological advance. Whereas looking backwards to the 1950s in the very first case study of a book looking at how technology will change the financial industry may seem a retrograde step, it serves to illustrate one point clearly. Information technology firms have no exclusive rights over innovation; to make a success they need a partner who can show them how the new technology can deliver an end result on which a firm or an individual will place value.

Case Study 1: Bank of America

ERMA—Electronic Recording Machine, Accounting—is one of the most significant of the early computers developed at the start of the 1950s. Bank of America approached the Stanford Research Institute to develop an automated method for processing checks. They wished to build regional check-processing offices, taking much of the process out of the front office.

Stanford came up with the concept of using a computer matched to electronic ink (MICR) so that the computer could automatically trace the origins of the check, and through pre-processing via imprinting the check details with MICR code, where payments had to come from and go.

A team lead by Barney Oldfield at General Electric wanted to enter the computer industry—against the wishes of the board that wished not to spend vast sums on what was then a very speculative and risky business. After seeing the Stanford machine and telling Bank of America that his division of GE could build these machines, he went back to his team with a $30-million contract for 40 machines.

The full impact of this first contract from a commercial company for a computer to do commercial work (rather than the scientific work they were being used for in, say, the nuclear power industry) was immense. To put it into context, only two years earlier government officials engaged in encouraging the growth of the new technology had dismissed the possibility of such sales. One example was Professor Hartree:

> '...a total of four computers would probably be sufficient to meet the computational needs of Britain.'—D.R. Hartree, Professor of Mathematics at Cambridge University, October 1949 in evidence to the Brunt Committee, which was an important influence on post-war technology policy in Britain.
>
> Tom Watson Sr., Chief Executive of IBM, made similar statements! ERMA changed the scale of what was possible for the computer industry. It showed that if one regional bank would place such orders, for a technology as yet underdeveloped, then the scale of potential demand to replace the previous generation of electromechanical systems was enormous.
>
> An interesting footnote is that Barney Oldfield was sacked when the board of GE realized what industry he had taken them into; the price of success can be high, though they later developed what was for a short while the second largest computer company in the world.

The growing importance of technology to business strategy in the financial services sector is leading companies to explore new business models. Increasingly we are seeing the development of extremely close partnerships between the supplier sector and the financial services community. Financial services companies are recognizing their need to have access to the latest technology, but, conversely, wish to protect themselves from technological risk. Equally, technology providers wish to have access to financial services firms so that they can tap into business expertise when developing their products. In partnerships that work, the financial services company gets access to potential competitive advantage through advance technologies, while being assured that the supplier is sharing risk. The technology company gets business and industry expertise in developing products that are aligned with the industry's requirement, making them commercially viable when these are marketed to third parties.

Most institutions now use packaged IT solutions to mitigate costs, reduce project risk and speed product rollout. Others, however, also partner technology companies in driving forward certain key technologies to gain at least a short-term advantage over competition. In this book we shall see where technology providers and financial services firms can benefit from working together to push back the boundaries of what is possible in the creation of new financial service models.

Most banks, most of the time, are profitable, so why do they have to hunt competitive advantage? Would a more sensible strategy be to cut all discretionary IT programs to reduce costs and increase their profits in a stagnant market place? If the market were stagnant then this approach would certainly work.

However, most institutions are faced with an ever-changing environment. Those that have developed specialist niche roles may resist change and be successful, although this can only be a short-term approach; others cannot afford to ignore change even in the short run. Indeed banks and financial services companies are having to deal with an increasing pace of change in the competitive landscape in which they work, all of which requires some collaboration between the business and IT strategies. Some of the key issues they face include:

- Increasing competition—there is a rapid rise in competitive pressures from established institutions, from new competitors from other sectors, and from new greenfield entities
- A need to form new relationships to deliver the services customers now require
- A strong impetus towards increased economies of scale through merger
- A strong impetus towards increased economies of scope by selling more product types and increasing customer "wallet" share
- The development of international competition and global banking
- A step change in the way customers (retail, corporate and investment) expect to receive their services

- Increasing customer choice and mobility, making customer retention harder to ensure
- A need to develop strategies, channels and products that fit into an increasingly customer-led rather than sales-push environment. Customers now wish to own the relationship and create themselves the solution that they need.

Competition—centralization of delivery

Such an environment means that a policy of simple cost cutting to maintain margins in the face of increasing competition is not a practical strategic answer. Both new entrants and nimble established banks are implementing new techniques to strengthen their position in the market, which go beyond squeezing costs. Indeed, in the true sense of the term reengineering as it was originally conceived, many firms are simultaneously recreating themselves with lower cost structures, but with greatly improved customer service models and with new product types. They are able to work with lower margins but simultaneously improve their value to the customer.

One of the biggest changes in recent years has been the seemingly contradictory point that that while many operations have been centralized they have, in fact, improved their ability to make their services accessible to their customers.

Intuitively, in the past, the concept of centralizing operations and decision making while improving customer service and access would have seemed impossible. The argument would be that the point of contact with the customer, the branch, would be disenfranchised. It could deal with customer enquiries, but would have to defer to a central office for approving a loan, thus slowing down customer interactions and reducing service and sales levels.

This is no longer the case. The technology of delivering services from a central point has not only developed, it has also become widely accepted by the customer base as being a better way of interacting with financial services companies than using the branches.

The key developments, in order of development, in the retail financial market have been:

- Automatic teller machines
- Telephone banking

- Centralization of bank back-office functions (essential to new branch developments and support of centralized delivery channels)
- Electronic banking services
- In-store supermarket banking kiosks/branches
- Kiosk-based multimedia terminals at off-branch sites
- The return of the home-visiting financial salesman, using notebook technology
- Internet banking
- Integrated telephone/electronic banking—mobile phone/PDA services

Not all of these new channels may last the test of time for every bank, but such an environment is the only method of providing what the customer is looking for. They offer, in varying degrees:

- 24 by 7 banking
- The ability for customers to carry out standard transactions through self service
- No queues
- No need to travel to a traditional High Street banking site—near which customers no longer work and where parking is difficult

It is ironic, that by centralizing services, banks have begun to return to a culture of customer service. It was not that banks had lost this, simply the pattern of banking and the scale of it had left many customers without the option of a banker with any semblance of knowledge of their requirements. There are many reasons why this occurred:

- A rapid growth in population and in urbanization left many bank branches in the wrong location for customers to visit easily—especially with fewer people working near traditional High Streets.
- As Western economies have grown, individual wealth has accumulated with a largely unbanked populace swiftly opening accounts between the wars, and at an increasing pace after 1945, aided not least by the success of banks in improving transactional services to negate the advantages of cash holdings.
- As wealth continued to be generated, customers began to require more financial services, such as insurance and mortgages. These

were not services offered by banks in the past and few customers used them.

- As urban areas grew so too did the level of population movement in most developed countries; this continues to be the case and reduces the reliance on a single branch for acquiring financial services.

These developments, together with bank mergers, the development of the banking franchise and the growth in population, increased the number of customers per branch while decreasing the relative value of each customer (relative to the population as a whole, which was increasing in wealth across the board).

Being a member of the local golf club no longer meant that the bank manager knew his customer base. Further, the development of the ATM and the credit card challenged the traditional relationship between the bricks-and-mortar branch and the customer. This, an act of convenience created by the banking industry that has offered great consumer benefit, has had the side effect of allowing competition into the market place. The disconnection between customer and the branch, and the increasing tendency to associate a banking service with a card in the pocket and a brand image, allowed the development of new market entrants able to offer partial or full banking services without the need for the traditional branch.

Competition comes in many forms, varying in nature in different countries where separate banking, financial and legal frameworks exist. Nevertheless, all established European financial services sectors face the same general framework of competition. The competition they potentially face is developing all the time, and while the following examples represent a fairly powerful list of potential new competitors, in reality competition can come from many other directions.

Competition from overseas

The potential for competition in many European countries from overseas banks has been largely overstated in the retail-banking sector—until recently. In Chapter 4, we look at building a global retail-banking brand and consider some of the concepts being used to achieve this. A new threat has truly arisen, based on new technologies, new branding methods and new channels to market: the threat of overseas entrants into the market.

In recent years, we have seen this threat develop, from the likes of credit-card firms from the USA with new methods for the marketing and targeting of credit cards using brand partners, or from overseas acquisition of insurance firms. Meanwhile, the advent of the euro may mean that a rationalized European market may not be many years away. Pan-European ownership of retail financial services companies (already the clear trend in insurance) is likely to be a major consequence of the euro.

Competition from financial services companies increasing their franchise space

Obviously one of the key forms of increasing competition in the total financial services market place has been firms moving from one sub-sector into another. In many countries (such as the USA and Japan) brokers, insurance companies and banks have been restricted from competing in each other's space. In Europe, rules have not been so tight and the development of bancassurance or Allfinanz has become common. However, as restrictive practices around the world end, or as the need for regulation to prevent monopoly, control of financial services recedes, then greater cross-sector competition will develop.

The reasons for a firm from one sub-sector entering other parts of the financial services industry are quite straightforward:

- They already have a developed brand in financial services.
- They have knowledge of customer behavior in buying financial services.
- They have expertise in creating and managing financial products.
- They have a distribution network.
- They have knowledge of the process involved in financial sales and transactions.

However, often it is only the first three reasons that they actually exploit. The "crossovers" often use a new direct method to enter new sectors. They choose the direct model for a number of reasons:

- They can gain a cost advantage over entrenched suppliers.
- It is a logical way to develop such channels for the mainstream businesses they have.
- Although direct channels initially tend to have a high capital cost, they offer lower transactional costs later.
- It does not risk current business or antagonize direct sales forces or commission-only independent financial advisers.

Later we shall look at some examples of this process. Among the most discussed developments in the crossover of a financial service from one sector to another has been the creation of Direct Line, the leading force in UK motor insurance, which was set up by the Royal Bank of Scotland. Its success has not only led it to become heavily involved in the rest of the insurance market, but, ironically, for Direct Line itself to cross over into providing banking services!

In the USA and Japan such moves are also taking place. For example, Chase has recently established an insurance subsidiary, while banks and brokers are beginning to merge in Japan. The floodgates will open as legislation changes.

Competition from non-financial services companies

Sometimes it is not other financial institutions that are most threatening to a banking franchise. After all, many banks will recognize that the insurance industry is not necessarily the most dynamic of environments, with many organizations lacking a certain entrepreneurial drive. However, it is not only financial services companies that expand an established franchise. Other companies also have profiles that they believe will give them some kind of advantage in selling a financial service. Some of these advantages could include:

- An established chain of distribution outlets capable of moving from simple retail to all consumer services or to a suite of complete "lifestyle" services
- Ownership of a successful direct-sales franchise
- The manufacture/distribution of products to which financial services can be attached
- Customer knowledge

In the USA, banks have been swift to move into supermarkets and shopping malls to extend their service coverage to where customer actually prefer to do their shopping. In other countries, some of the storeowners have noted the US development and instead of simply leveraging their real estate by selling space to banks, have used their loyalty schemes, their coverage and their brand to enter financial services. In the UK retailers such as Tesco and Sainsbury's have sought greater control over the in-store branch by establishing their own banking brands with partner banks which simply act as transaction outsourcers.

Meanwhile, car companies have developed a number of financial service models, based on loyalty schemes, direct car lending or even using their knowledge of high-value customers to establish mainstream banking services. Others such as the Virgin Group in the UK have used a branding advantage to establish themselves in a niche for younger affluent customers.

True "greenfielders"

What is the appeal of financial services to "new age" entrepreneurs? It is understandable why young educated entrepreneurs rushed to Silicon Valley, less obvious why they should be interested in retail financial services, an old industry selling well-established products. However, new banks such as Security First have proved that, when combined with new technologies, banking still has the ability to attract the next Mr. Rothschild or Mr. Mellon. Entrepreneurs are still looking at the financial services market as a clear route to success.

Table 1.1: Examples of recent entrants into the UK retail financial services market

New bank/outlet	Banking partner	Ownership structure	Products	Notes
Sainsbury Bank	Bank of Scotland	55% Sainsbury 45% BOS	Mortgages Savings Xmas Saver Visa Loans	
Tesco Personal Finance (RBS)	Royal Bank of Scotland	Joint venture 50:50	Instant access savings Visa Loans Foreign Exchange	Also distribute Direct Line and Scottish Widows (RBS partner) products Tesco runs own call centre Currently links instore ATMs, etc. via RBS network
ASDA	Lloyds	Lloyds instore branches		Pilot
Safeway	Abbey National	Abbey instore branches		Pilot
William Morrison	Midland	Midland instore branches		Pilot

Table 1.1: Examples of recent entrants into the UK retail financial services market, *con't.*

New bank/outlet	Banking partner	Ownership structure	Products	Notes
Virgin Direct One Account	RBS		Mortgage/ savings/ current account Checkbook Visa/Switch ATM	Virgin call center— RBS product
Legal & General Bank	Clearing services only	100% L&G	Mortgage	Insurance industry entrant
Prudential Bank—EGG Account	Clearing services	100% Prudential	Instant access high interest savings account	Insurance industry entrant

Delivering financial services through partnership

It is notable that many of the firms entering the financial services industry are doing so by forming alliances to build the key elements of their foray into the market. The alliance approach gives them new ways of creating financial products and services, technological infrastructure, channel outlets and branding.

What we are increasingly seeing are some banks adopting a new role as a financial services factory, including product development, processing and payment services. They are then working with new entrants that have decided to adopt a strategy based on exploiting their advanced distribution channels.

The roles played by different institutions are becoming very blurred. As financial institutions choose their strategies and as suppliers develop new techniques for supporting them, assessing the competitive landscape is highly difficult.

Financial institutions have a number of operating methods to choose from:

- Fully integrated full-service institutions

These are the banks, brokers and insurance companies that can afford to develop a wide band of products, sell them and operate and support them in house. These institutions need to fulfill a number of criteria to be successful. They must be large enough to support in-house products though efficient processing factories. To create this level of efficiency they need to have a large network of sales outlets to sell enough products to create the volumes needed in the processing centers.

In addition to a large sales network, (whether branches and/or direct channels) they must also be good at selling to create this high volume level. Methods of creating better customer focused sales environments will be a key theme in Chapter 3.

- Product builders—Process managers

In areas such as global custody, a group of major and not so major international banks have begun to recreate themselves as managers of a process, that process being the guardianship and transfer of international financial instruments and money. Firms such as State Street and Bank of New York are major suppliers to the rest of the industry.

In the retail sector, we are just starting to see the equivalent—the process managers. Like the custodians, these institutions take on the processing work that in the past would have been the internal responsibility of each market participant, and indeed would have been the entry ticket into the sector. In the card market, MBNA and HFC are clear examples of this development.

However, as new entrants move into the finance industry, these process managers have expanded to include creating the products sold by new-player entrants. They create and then support products on behalf of greenfield companies via their processing factories. Banks are exploiting their own product and processing capacities and capitalizing on economies of scale by allowing firms that tackle a different sector of the market to sell their products.

For example, Virgin's One account is actually a Royal Bank of Scotland product created specifically to target the types of customers Virgin wished to acquire—young affluent people, often with self employment or with contractor incomes. Royal Bank of Scotland is very concentrated in Scotland and is seen as a traditional institution. Virgin gives them a strong brand in the much larger and more affluent English market—a strategy they are carrying out with a number of other partners.

The goal is to combine the processing needs of multiple vendors into concentrated processing factories and gain economies of scale to compete with the large full-service institutions or, where successful, surpass them and encourage them to join the service themselves. The majority of such institutions will be traditional ones—with access to clearing systems and