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UNIVERSAL BANKS: THE NEED FOR CORPORATE RENEWAL

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Abstract

In the past 10 years, many universal banks –i.e. large, diversified banking groups– have experienced a dramatic decline in economic performance in many industrial countries. Some authors attribute this fall to the lack of focus of universal banks and have proposed alternatives such as the concept of “core banking” or “the functional approach”. In this paper we argue that these proposals are useful but incomplete: universal banks have to consider all the elements of corporate strategy, just like any other diversified company, including the positioning of each business unit in its market, the development of basic capabilities that will allow those units to differentiate themselves from competitors and sustain a competitive advantage, the relationship between each unit and the corporate center, and the organizational structure that will support the universal bank.

UNIVERSAL BANKS: THE NEED FOR CORPORATE RENEWAL

1. Introduction

The banking industry is experiencing a huge shake-up in industrial countries. Mergers, acquisitions, hostile takeovers and bankruptcies are prominent items in today's banking news. However, they reflect deeper, more far-reaching changes in an industry that is cyclical, that is seeing declining profits and mounting rivalry, and that is plagued with excess capacity. Deregulation, financial innovation, disintermediation and new technologies are playing a major role in making some financial services obsolete and eroding the competitive position of major players (1).

The banks' initial reaction to these new challenges has been very proactive. Some banks, especially in Europe, have become universal banks, that is, providers of a large variety of financial services, from checking accounts to derivatives, from corporate loans to financial advice on mergers and acquisitions, from bond trading to active shareholding in industrial companies.

Crédit Lyonnais, one of the largest French banks, was the paradigm of this approach. Its rationale boiled down to an attempt to avoid the substitution risk whereby old financial services are simply replaced by new ones, and so it embraced all of them through a large number of business units under the same organizational umbrella.

Crédit Lyonnais undertook the most ambitious bank growth experiment in Europe during the 1980s and early 1990s. When one talks of global European banks, two names spring to mind: Deutsche Bank and Crédit Lyonnais. They shared the same banking philosophy and adopted the "universal banking" model, in which banks play a significant role in financing and controlling industrial companies. They believed in the need to be active in the various European countries, either through internal growth or by buying local banks.

The subsequent history of Crédit Lyonnais is eloquent. Its capital increased from 37 billion francs in 1988 to nearly 80 billion francs in 1993. Its lending activities increased 2.5-fold during the same period and its financial performance went from a profit of 3.7 billion francs in 1990 to losses of over 7 billion francs in 1993. At the same time, this strategy led it to the pinnacle of glory in 1993 as the largest bank in the world in assets, after the Japanese banks. Its assets at the end of 1994 amounted to 2.3 trillion French francs. Crédit Lyonnais was the bank that couldn't say no to any growth opportunity.

The drawback of this growth was the bank's falling profitability. The mounting losses were mainly due to large provisions for bad loans, the losses generated by its industrial holdings, and its high operating costs, which in 1993 swallowed up more than 70% of the bank's total revenues (in a well-managed bank, 60% is more normal). Table 1 shows some of the industrial holdings that gave Crédit Lyonnais so many headaches.

Table 1. Crédit Lyonnais: Corporate shareholdings (1994)

Business	*Industry*	*% capital*
MGM	Leisure	100.0
FNAC	Distribution	66.0
ARNAULT	Luxury	29.5
USINOR SACILOR	Steel	20.0
ADIDAS	Sport	19.9
AEROSPATIALE	Aerospace	18.0
BOUYGUES	Construction	10.0
RHONE-POULENC	Chemicals	6.0
LAGARDERE	Publishing and defense	3.0

Source: Crédit Lyonnais.

Crédit Lyonnais' financial problems forced the French government to step in to rescue the bank on two occasions: first in early 1994 and again in April 1995. Together with the problems caused by a probably low-quality management and a lack of rigor in lending to companies associated with the bank, Crédit Lyonnais was an example of the major hurdles facing universal banks with large business holdings.

The French bank was not alone in undertaking this diversification process. Other large European banks such as Deutsche Bank, Banesto or Natwest went down the same path and obtained meagre results. The worst case was Banesto, which had to be put into administration in 1993 by the Bank of Spain and was rescued by other large banks.

Other financial powerhouses followed a different course. Instead of a business diversification strategy, some banks aggressively pursued an internationalization process, entered into other markets, grabbed market share from local rivals, offering either corporate banking or retail financial services, or both. ABN-Amro, Bank of America, Dresdner Bank, Barclays and Citicorp (See insert "Citicorp's International Growth") became pugnacious rivals in other industrial countries. Their key goals were growth and market share.

Dresdner Bank's diversification illustrates some interesting dimensions of this growth process. In June 1995 Dresdner Bank bought Kleinwort Benson, one of the leading British investment banks. Following Swiss Bank Corporation's bid for S.G. Warburg, this was the second acquisition of a major British investment bank that year.

The premium Dresdner paid for Kleinwort Benson's shares was very high. It reflected, according to Dresdner's Board, the highly attractive positioning of the British bank in the global market for mergers and acquisitions and state-owned company privatizations.

For Dresdner, the acquisition had another attraction: the opportunity to diversify its efforts into investment and international banking by acquiring one of the leading firms. It is very difficult to figure out how a universal bank with very limited experience in investment banking could enter the industry without a link of that type.

Dresdner now faces two new dilemmas. First, how to integrate the investment bank into its old structure without alienating too many people. Second, what value Dresdner management will contribute to Kleinwort Benson in order to sustain its advantages in a very competitive segment of the financial services industry.

Banks like Dresdner have built up a dense local network of branches in foreign countries. The commitment of capital has been immense. The outcome: after several years of tense struggle in foreign markets, most international banks are pulling back and plan to rethink their strategy and the best way of allocating their scarce financial resources. The reason: most of them underestimated the cost of entry into foreign countries, the incredibly high speed of imitation in financial innovation, and the sharp rivalry in other markets. Of all the banks mentioned above, only Citicorp still holds on to its resolution to be a global universal bank.

Citicorp's International Growth

The international expansion of Citicorp during the 1970s and 1980s testifies to a remarkable effort of growth and diversification and was based on a series of critical actions. First, the creation of a holding company to guarantee that each of the bank's businesses had the decentralization and initiative it needed. Second, the consolidation of a strong retail banking sales network in many foreign countries, aimed at providing all types of financial services to households and individuals. Third, the penetration of financial markets, particularly the foreign exchange market, with all manner of financial instruments, in some of which Citicorp is still market leader. Fourth, major investments in information technologies. The path taken demonstrates a vision of the financial services industry that goes beyond mere financial intermediation to the provision of financial services in an increasingly uncertain world. In this new world, information management is becoming a critical factor in the future of banking.

Citicorp's strategy was presented and consolidated under the name of the five I's: institutional banking, individual banking, investment banking, information technology and insurance. In the 1970s the bank's business increased both in volume and in degree of diversification and complexity. However, in the early 1980s, particularly with the recession in the United States and the foreign debt crisis, Citicorp started to suffer increasing difficulties in managing the giant conglomerate, with its unprecedented business diversification and geographical expansion.

In the mid-1980s, Citicorp refocused its different businessess. Among the decisions taken, it is worth highlighting the curtailing of the scope of the activities of the investment banking division, which created hostility among some of the bank's senior managers, and the decision to grow the retail banking unit, which was the most profitable and least risky for the bank. This action also included international growth. Although the retail banking division's performance had been poor during the late 1980s, in recent years it has generated 60% of the bank's total revenues and the tendency is for this proportion to increase. Meanwhile, the lending business –particularly loans in developing countries, loans to companies, and financing large-scale projects– was experiencing major difficulties. A second important decision was the heavy investment in information technologies, in part to strengthen the retail banking service by introducing new services such as telephone banking.

Another major headache for Citicorp has been the investment banking division, which started to operate separately from other divisions in 1982. This unit was spun off from the other businesses to give it a greater entrepreneurial thrust. However, Citicorp came up against a problem that other retail banks, such as Bankers Trust, have also had to face when they decided to follow this path: the need to pay very high compensations to the professionals they wanted to attract, in line with what other similar organizations were paying.

Citicorp's main problem was that its commercial banking unit was much bigger and more profitable than this new division. Therefore, to discriminate in favour of professionals because of the division they were working in, when they had not even proven themselves, could create thorny problems in a highly competitive organization like Citicorp.

The economic recession in the USA at the end of the 1980s once again severely dented Citicorp's results. The downturn in company profits and the fall or stagnation of family incomes meant increased payment arrears and falling profits for the bank. Citicorp's poor performance at the end of the 1980s made it more difficult for the bank to place long-term debt issues or capital increases to finance its growing investment needs.

The growing complexity of the financial services industry due to the intense global rivalry in the various segments of financial activity was also evident. In the late 1980s, Citicorp seemed to be one of the organizations that was suffering from the consequences of being a universal bank and having to compete with a large number of financial institutions that were more specialised and focussed in their respective businesses.

Citicorp is still the bank that offers the widest range of financial services in the United States. Thus, the retail banking unit is very strong in many financial services, particularly credit cards and mortgage loans. In credit cards, Citicorp is the top US bank and the second largest financial institution, after American Express. Finally, the retail banking unit has powered Citicorp's international expansion in recent years.

Citicorp has paid a high price for its strong global expansion. By the end of 1994, the bank was operating in more than 90 different countries and had a total of about 88,000 employees. It is a well-known fact that financial patterns vary from country to country and therefore a considerable amount of local adaptation is required.

Faithful to its management philosophy, Citicorp initially tried to operate as uniformly as possible in all countries by exporting its unique skills, developed in the United States; but the fact is that it has had to modify this policy in view of the poor results obtained. A striking case of this organizational crisis is the bank's division in Europe, which underwent a number of major changes in focus in just five years, bewildering employees and customers alike.

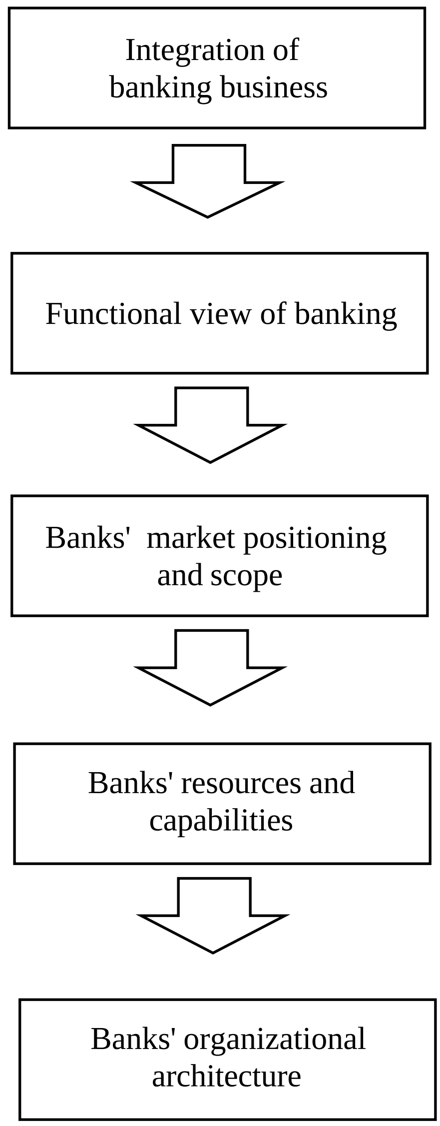
Citicorp's clout in the financial services world is undeniable.The question that still remains to be answered is whether a global universal bank like Citicorp can manage its different businesses in so many different geographical markets with the same efficiency as a local specialist. Again, the conflict between size and flexibility appears to be a critical issue for Citicorp.

Do the cases just described have any underlying features in common? Do Crédit Lyonnais or Deutsche Bank have any strategic features in common with Barclays or Natwest? They do. What these banks have in common is the belief that, in the new banking world, banking group managers can change their bank's positioning by making large bets into untapped markets or new emerging segments. They have committed too much equity in businesses with mediocre prospects. They seem to lack focus in their business portfolio. Their business units are loosely connected and poorly coordinated. They rely more on market share than on efficiency. All in all, they seem to lack the managerial capabilitites needed in the new global financial system.

Most of these banks shared the idea of integration. Universal banks had a tendency to get involved in a large number of financial businesses and integrate them within a single group and under the same management. A new approach, however, seems to emphasize banks' need to go beyond integration and adopt a functional view of banking.

This new perspective is innovative and widens banks' strategic vision. Nevertheless, we argue that they should not stop here. Their mission pushes them to move from business integration to a functional view, and from there to an understanding of the drivers of competition in each business and a definition of each one's market positioning. From market positioning they must move on to discover, nurture and foster the resources and capabilities that support this positioning. Lastly, these resources and capabilities must be embedded in a new organizational architecture. This is the chain of questions that universal banks have to consider and the perspective that we shall be discussing in this paper (See Figure 1).

Figure 1. A different view of universal banks



2. From Integrated Banking to a Functional View of Banking

For many decades, integration of activities seemed to be the dominant strategy among banks in many countries. In order to deal with new challenges or the threat of competition, banks simply added new activities under the same corporate umbrella. The effort of adapting to market changes consisted mainly of incorporating new business units, without replacing the old ones. This fashionable trend had two major effects on banks. First, different business units demanded increasing amounts of capital and competed with each other for new capital investments within the group. Second, the addition of new units, without rethinking the purpose of the whole group, merely added to the complexity and caused headaches for corporate managers. Falling profitability and an inadequate management model make the integrated banking framework look obsolete.

It seems obvious that in this context of falling profitability and declining market share, banks want to figure out how to get out of this trap. They do not want to hear anymore the fateful question: “Is banking dead?” One of the answers put forward in recent years is the concept of “core banking” or “narrow banking” (2). This concept is intended to help banks focus their portfolio of business units and provide customers with safer financial instruments, and to make it easier for banks to monitor financial regulators.

The “core banking” proposal assumes that banks should define their core businesses, which would include the traditional commercial banking activities: taking deposits and paying interest at market rates, and extending loans to small and medium-sized companies and private individuals. Under this proposal, the deposit insurance would cover only those deposits and operations that could be included in this category of activities. Other riskier financial activities such as corporate lending or derivatives –today undertaken by many universal banks– would be excluded from the insurance.

If universal banks were to be organised around this concept, the industry would undergo a number of dramatic changes. In the large European Union countries, of each dollar currently held in deposits, at the end of the process there would be only 0.5 dollars. The remaining deposits would migrate towards higher yield, more volatile financial instruments. The industry would also become more concentrated, as the more profitable banks would take over the smaller banks.

Universal banks would also need a certain amount of restructuring. They have been engaging in increasingly sophisticated activities on financial markets while remaining very active in traditional commercial banking. In the future, universal banks will gradually disconnect their basically commercial banking activities from their money market operations and large-scale corporate financing, in order to improve management in both areas and prevent the risks taken by the capital markets divisions from being passed on to the banks’ depositors.

Furthermore, if this restructuring of the banking industry actually happens, the nature of banking will no longer be so global. Indeed, only certain international financing operations, for which it is vital to have access to the international markets and in which scale economies are clear, will be unequivocally global. Instead, commercial banking will continue to be predominantly national in scope, as the national banks’ networks of branches raise formidable entry barriers to penetration by foreign banks. The economies that might lead to the globalization of commercial banking are not so apparent.

The question that remains is whether this separation will be attractive to the banks. The answer might be yes. The reason is that commercial banking activities are reasonably profitable and the risk they entail is relatively small. Some regional banks in the United States and Europe report a return on capital of between 18% and 25%. For their part, investment banking activities or the financing of real estate projects offer opportunities for substantially higher returns, but at the same time, their risk is much higher and they are much more sensitive to business cycles.

Separating these activities has another advantage: it would reduce the risk borne by the depositors. Furthermore, the cost of a deposit insurance to cover the risk of a bank becoming insolvent would be lower, as the risk covered would be limited to typical commercial banking operations.

This might also have the effect of discouraging banks from undertaking excessively risky operations, as the deposit insurance safety net would no longer cover operations that could not be strictly considered commercial banking. The TBTF ("too big to fail") rule would no longer apply and the more solvent, better managed banks would no longer have to pay for the shortcomings of less well managed banks.

The message from the "core banking" approach seems to be clear. Separation of activities within a bank seems to be prompted by two main considerations. First, efficiency in managing each of the bank's businesses. The skills needed to operate on the capital markets are not the same as those required to operate as a good commercial bank. Also, the skills required to successfully manage a diversified financial group are many and varied, and –judging from the European and American experience– they are in very short supply.

The second reason for separation of activities has to do with the mechanisms for protecting investors. It seems reasonable that the cost of managing higher risk activities should not be borne by lower risk operations –commercial banking– or the taxpayers. Consequently, Central Banks, in cooperation with the banking system, will only guarantee with a deposit guarantee fund those activities that are carried out under the umbrella of commercial banks.

The core banking approach has a tremendous advantage: it might help banks distinguish more clearly between successful and unsuccessful businesses. The snag with this approach is that it is more a recipe for financial regulators with an interest in protecting small investors from banking crises than a model to help financial institutions think about their strategic options.

A more interesting approach for banks comes from the functional approach to bank management (3). This concept derives from simple facts. Modern financial systems have to perform certain financial functions, such as a formal and well organised payments system. The financial functions traditionally performed by banks meet customers' needs. The underlying message of this new concept is that financial institutions change, but basic financial functions remain. The functions do not change because they still meet basic needs, although they might be offered to final customers with a different technology.

The present configuration of modern financial systems is the result of a large number of historical factors, such as the development of the early industrialization processes, the role played by financial organizations in this process, the degree of government intervention in the private sector, or a country's savings patterns as shaped, for example, by the tax system.

With all the necessary caveats, the financial systems of industrialised countries have been formed in accordance with the principle of efficiency in resource allocation. In other words, the decisive factor behind a given financial system is the perception, maintained by the various actors in a country, that one particular framework, rather than any other, is or has been the best for articulating the financial system in order to guarantee the resources required for investment.

The financial system's efficiency in allocating resources has several dimensions that involve providing certain functions. First, that of intermediation as such, insofar as it ensures a flow of financial resources towards the real sector of the economy at competitive prices.

Second, monitoring the risk borne by savers. In this respect, the financial system must articulate mechanisms to measure, at any given time, the risk incurred by banks, with a view to controlling it or to limiting or broadening the risk of a particular investor.

Third, the financial system should provide suitable opportunities for risk diversification. It is not enough to control risk; it is necessary to enable savers to reduce as far as possible the variability of the various financial assets' price and yield.

Finally, the financial system must implement the necessary mechanisms to reduce the risk of a financial crisis –normally, in the form of supervision by the financial authorities– and mitigate, when necessary, the effects of such a crisis.

The functional approach to banking is a novel and promising idea that will help many bank directors think about the way they diversify their activities, reorganize their business portfolio and plan the launch of new financial services.

This view of banking helps bridge the gap between what bank directors have to do in terms of external markets and what they have to do for their customers, but it does not show how to rebuild the banks' internal organization.

The emerging new paradigm in Strategic Management emphasizes both the external assessment of the industry and the internal evaluation and development of the resources and capabilities that the organization has or should have in order to add value to customers while increasing its own worth.

The functional approach is a good starting point because it signals the functions that an individual bank can perform. Simultaneously, however, the bank has three additional aspects to consider: its new market positioning, the resources it has to help it sustain that positioning, and how it can be reorganized internally to align resources and market positioning.

3. From the Functional View of Banking to Market Positioning: The Choice of the Business Scope

The functional view of banking sheds light on a basic puzzle facing many banks: how to compete with financial institutions that offer innovative financial services. The answer that the functional view provides is simple, but clear: the key is to look at the functions that those services try to perform. Sometimes, they may address just one function; other times they may repackage a number of different functions with just one financial instrument.

How to define the functions that a bank wants to perform is a more concise, more specific and clearer question than thinking about adding new businesses. It allows banks to reflect more deeply on the integration of new businesses or the separation or disposal of old ones.

In the banking industry, the integration of business units takes a special form nowadays: universal banking. Universal banks are diversified financial companies, usually built upon a powerful retail bank, with many solid pillars such as investment banking, derivatives or insurance companies. This concept of banking has been adopted in Europe and Japan, but still has some problems with US regulators, who doubt the soundness of a banking system in which banks carry out all sorts of financial activities, including direct lending to companies and active banking shareholding in non-financial companies.

Nevertheless, the modern version of this dilemma for banks is diversification of activities versus specialization, or the relative advantages of universal banks and specialized banks. In other words, banks have to decide the scope of their activities and weigh the advantages of scale and scope against those of flexibility, simplicity and specialization. Let us briefly discuss the key advantages that universal banks seem to offer compared with specialised institutions.

From the viewpoint of banks, the arguments for or against universal banks vis-a-vis specialized banks can be articulated around the following points. First, the economies of scale and scope versus the economies derived from possessing experience and expertise in particular activities. Second, the ability to attract or retain customers by being a financial conglomerate that offers a broad range of financial products (the advantage of a universal bank), or by having a reputation for professional excellence in specific financial services (the advantage of a specialized bank). This second point raises the question of the advantage of being able to compete more effectively in different markets or with different products compared with the advantage of cross-selling products to the same customers. Third, the risk of banks being supplanted by other companies. We shall discuss each of these arguments to see if they shed any light on the debate between specialised banks and universal banks.

Scale and scope economies

Universal banks may offer two major types of cost advantage. First is the advantage arising from possible economies of scale. The larger the volume of operations for a given level of overheads or investment, the greater the organization’s efficiency. Second, there is the advantage of sharing costs between different business units, so that the total cost of having certain services offered by different units is greater than the cost incurred when they are offered together: these are what are known as economies of scope.

For their part, specialised banks primarily offer the advantage of their experience in specific products or services and a reputation for excellence in their chosen segment of the banking business.

Which of the two arguments is stronger: the economies of scale or scope, or the presumed economies of experience and the benefits arising from a strong image of excellence in certain services? There is no single answer. The empirical evidence available (see insert “Scale and Scope Economies in Banking”) can be interpreted in more than one way; it conveys a certain amount of skepticism regarding the size of the economies of scale and leaves the door open to possible advantages arising from economies of scope.

The basic problem facing universal banks in their efforts to realise economies of scale and scope lies in the process of amalgamating, managing and coordinating different businesses under a single umbrella. In other words, the benefits are not always reaped immediately because the job of managing universal banks has become extremely complex.

Discussion of these concepts should be coupled with a study of the actual experiences of specific banks. In many countries, we find successful universal banks and disastrous specialised banks, and vice versa. Among the successful universal banks, we could mention Bank of America, Banco Santander or ABN-Amro Bank. Successful specialized banks include J.P. Morgan, Banco Popular, Banc One or Crédit Suisse.

If the advantages in one direction or another were clear and unequivocal, then banks would tend to focus on one of the two alternatives, so that there would be either a majority of specialised banks or a majority of universal banks. In real life we find better or worse managed banks in both camps, which forces us to conclude that, ultimately, the bank’s performance depends more on the quality of its management than on the degree of specialization or diversification of its activities.

Scale and Scope Economies in Banking

The empirical studies carried out to discover whether or not universal banks do in fact enjoy economies of scale have not yielded any categorical results. From a methodological viewpoint, in a universal bank one should distinguish between economies obtained in each of the bank's activities or business units. For instance, a universal bank might enjoy scale economies in its investment banking and securities units, but not in traditional commercial banking. Most of the empirical literature on scale economies in banking focuses on commercial banking. Many studies seem to confirm that economies of scale in commercial banking are exhausted at very low deposit levels (less than 100 million dollars in deposits).

These results need qualifying; it has to be pointed out that in certain segments of financial business it is possible to observe economies of scale, although they may not be very significant. For example, some studies show that in the securities industry the minimum scale of operations is 30 million dollars in annual revenues (*).

However, these studies suffer from marked limitations. Studies of individual countries include only a small number of truly universal banks. On the other hand, the studies carried out in the United States are not significant in this context as the concept of the universal bank still does not have the meaning it has in Europe, owing to the regulatory limitations within which US banks operate.

Furthermore, empirical studies have the disadvantage that they do not reveal or discuss the nature of the sources of the economies of scale or scope in universal banks, many of which may be very subtle and difficult to measure, as is the case with the brand image of the group as a whole.

(*) For a review of the empirical evidence see A. Saunders and I. Walter (1994): Universal Banks, Oxford University Press, New York.

It is not difficult to follow the trajectory of universal banks that have ended up as business disasters. However, we can also point to a number of specialized banks with a narrow range of products and services that have been forced by the industry's competitive dynamics to withdraw from the industry or be taken over by or merge with other banks. Some regional banks in France and Spain provide good examples of this. In short, experience with universal banks and specialised banks shows that it is not possible to generalize. There are successful specialised banks and universal banks with problems, and vice versa.

There are at least two further points to be considered. First, the question of specialization or diversification of activities has to be placed in the context of an organization's history, resources and capabilities. When a bank has the resources and capabilities to carry out certain activities, the question of specialization becomes less important. This point will be explored later.

The second factor to be mentioned is that a specialised organization runs a greater substitution risk than a universal bank, for the simple reason that its business base is more limited and therefore more vulnerable to drastic changes in the financial services industry. By contrast, a universal bank that offers several, more or less interrelated products and services is able to balance its various businesses, according to its internal resources and the dynamics of competition in each financial product. In other words, to use a concept taken from Finance, a universal bank has an option to penetrate emerging segments within the financial services industry more quickly.

The advantages of being a major supplier of various financial services

One of the arguments used by universal banks is that they can provide a wide range of financial products and services, so that their customers do not need to depend on a variety of different banks to obtain different financial services. Or, to put it another way, universal banks may hold a greater appeal for customers than specialized banks on account of the comprehensive range of services they offer. If a universal bank were not to offer the more innovative products or services supplied by a specialized bank, it might find it difficult to gain new customers or retain old ones.

This latter case is illustrated by recent events in the French, German and Spanish financial systems. The explosion of investment funds as an alternative to traditional savings accounts has forced the universal banks to enter this segment of financial business, which goes beyond the mere taking of deposits, in order to offset the slower growth or actual fall in checking and deposit accounts. Therefore, for some financial organizations, universal banks could be the model to imitate if they do not wish to lose operations, customers or both (see insert "Financial Conglomerates").

Financial Conglomerates

Some recent cases in the US and Europe show a few of the problems of financial conglomerates. American Express is a case in point. During the 1980s it competed with varying success in different segments of the financial market, although its results were not exceptional.

American Express was the first company to market –in 1890– the concept of travellers' cheques. After the Second World War, it started to expand abroad and in 1950 introduced its credit card. From then on, American Express embarked on a diversification that was consolidated in three business units until the end of the 1970s. First, the Travel Related Services Division, which included travellers' cheques, credit cards and a travel agency. Second, the American Express Banking Corporation, which carried out banking activities outside the United States, mainly in developing countries. Finally, the Real Estate Division.

In April 1981, American Express's situation changed drastically when it decided to merge with Shearson Loeb Rhodes, one of Wall Street's most active investment firms.

The main reason for this merger was the supposed synergies to be obtained by combining the two companies. It was decided that the new organization would act as a holding company that would supervise each of the group's divisions.

The main problem that the new financial group came up against was not simply the difference of culture, but the fact that the very nature of the two companies' businesses was extremely different and important transactions had to be approved at different management levels. This apparently harmless control mechanism had lethal effects on Shearson's securities trading business, which required –and still does require– on-the-spot decisions.

Shearson continued to grow, buying other investment banks when the opportunity arose. Thus, it bought Lehman Brothers Kuhn Loeb in 1984 and L. Messel (London) in 1986.

However, the growing competition faced by the group's various business units during the final years of the association exacerbated management problems to the point where the profitability of both American Express's units and Shearson's business took a severe plunge. Finally, in 1993, as part of a large-scale restructuring plan, American Express decided to sell its investment banking business.

Another case that illustrates the problems involved in creating large financial groups is that of Prudential Bache, which was born from the purchase of Bache Halsey Stuart Shields by Prudential in March 1981. Prudential was the largest insurance group in North America and Bache was a securities broker operating on the North American stock market.

The main reason that led Prudential to make this move was the idea that a financial supermarket made sense, in the early 1980s, owing to the large number of synergies that were perceived between the different businesses. It seemed that if the two organizations sold financial services to the same customers, they could make significant savings in information collection and processing costs and distribution costs.

In particular, Prudential hoped that Bache would enable it to offer new financial services to its insurance customers, and that it would also be able to attract Bache's high income customers to its insurance business.

However, Bache's internal problems prevented these advantages from materialising during the first years. Then, three years later, Prudential decided that the trend in capital market trading was towards the investment banking business, that is, one step beyond the mere purchase and sale of shares and debt instruments.

This was the path that was already being followed by other organizations with more experience than Prudential, such as Citibank or J.P. Morgan. Stiffening competition and the stock market crashes of 1987 and 1989 played havoc with Prudential-Bache's results, to such an extent that the group went into the red in 1989 and 1990.

At this point, it should be pointed out that, in real life, companies usually work with several different banks at once, which suggests that the concept of the one-stop supplier of financial services may not fit in with business reality. However, when a universal bank has a good customer, it has a greater chance of satisfying a greater number of that customer's financial needs.

We would like to stress that in this section we are not referring to costs, economies of scale or economies of scope. We are referring merely to the ability to attract and retain customers.

A variation on this argument is that universal banks are usually larger than specialized banks. A larger size is usually interpreted by the customer as indicating greater solvency. Scale acts as a signal to investors. This credibility or reputation factor may be particularly useful when gaining new customers or retaining old ones.

A specialized bank, in contrast, usually has a reputation for experience or excellence in particular financial operations, such as private banking, securities, portfolio management, or financing operations for large corporations. In each of these fields, and in others, there are specialized banks with an exceptional reputation that is the key to attracting new customers. Names such as J.P. Morgan or S.G. Warburg enjoy a tradition of excellence in their activities.

Insofar as specialized banks are able to anticipate changes in the demand for the services they offer, their possible disadvantage vis-a-vis universal banks disappears. However, when this is not so, their vulnerability is greater than that of universal banks.

The potential advantages of specialized banks are related to an aspect that we have already mentioned: their resources, capabilities, and management quality. When a bank has this ability to adapt, it is less important whether it is specialised or universal.

On the same point, it is usually assumed that large organizations are harder to change, or that managing change is more complex than in small organizations. This may be true in some cases, but it is not a universal principle. Smaller organizations may well be more responsive to change, but let us not forget that it is people, not organizations, who manage and promote change. So, rather than universal banks versus specialised banks, it would be more correct to talk of well-managed banks versus not-so-well-managed banks that do not have the resources needed to compete successfully.

Universal banks, specialized banks, innovation and substitution

We mentioned earlier the substitution risk facing specialized banks when there is a drastic change in the demand for financial services or an acceleration in financial innovation.

By financial innovation we mean new financial products or services that have certain advantages over traditional financial products for savers and investors. Investment funds, futures, or the packaging of several financial services into a single product are just a few examples of financial innovation.

Financial innovation affects not only the products offered by financial companies but also the way they are distributed to customers. Enormous changes have taken place in the distribution of financial services. According to several Europe-wide surveys, bank branches are losing importance in relation to A.T.M. and telephone banking. Likewise, direct marketing is gaining ground quickly, in part thanks to the ever-expanding use of the telephone. Finally, smart cards are also eating away at part of the bank branches' traditional share of business.

This innovation process mushroomed in the 1980s for two main reasons. First, financial deregulation blasted apart the barriers that traditionally separated different types of financial firm, so that now all are competing on an equal footing. Rivalry encourages innovation and financial deregulation makes it possible to bring these innovations to market.

Second, the new information technologies have led to the wider availability of data on the situation of financial markets all over the world, thus opening up new business opportunities. They also open up different ways of distributing traditional financial products, such as current accounts or securities trading, or, alternatively, ways of serving customers for traditional products better and more quickly. Finally, the new technologies enable customer information to be handled in a consistent, systematic and strategic fashion and have become an indispensable tool for modernizing the marketing function in the financial services industry. Without this powerful tool, neither financial innovation nor the emergence of new competitors would have achieved the power and scope they currently have in many countries.

At first glance, it would seems as if specialized banks had won the financial innovation race. Hugely successful products such as mutual funds or intelligent credit cards were introduced not by large universal banks but by smaller and more innovative financial institutions. However, large universal banks have also been very active in some areas.

Nowadays, one of the most popular and promising new products is telephone banking. In spite of a number of early failures, such as that of Chemical (1980), phone banking is gaining a firm foothold in the banking industry. In Britain, First Direct, a subsidiary of Midland Bank, has achieved quite spectacular results. In Spain, Bankinter, which belongs to Grupo Santander, has pushed the concept hardest, changing the bank's operational procedures.

Phone banking has also been used by foreign banks to gain market penetration in other countries. For example, Citibank has used it to increase its presence in a traditionally difficult market, Germany. In 1973, Citibank bought KKB Bank, one of Germany's oldest commercial banks. Over the following 20 years, Citibank's business grew at an extremely slow rate. In 1992, however, it introduced the round-the-clock telephone banking concept, which enables users to carry out any type of operation with the bank from anywhere at any time.

This service was launched shortly after the appearance of another revolutionary financial product in Germany: the "Formula One" high interest-bearing current accounts. Both services have given a significant boost to Citibank's business. In the course of just one year, the number of customers grew by 11%, revenues by 13% and earnings by 55%. Also, in 1993, productivity per employee in Citibank was 20% above the German banking industry average.

Let us consider the case of a universal bank that is weighing up the possibility of entering a new emerging business. The bank needs to answer the following questions: How much of a threat is there that other banks will take the initiative and lead these businesses? Are there clear advantages in being the first to develop and market this particular financial innovation? How many customers will be lost in the traditional business if we enter this new business? Does the bank have the necessary skills to compete in this new business? Is there a risk of being supplanted by other more innovative banks?

These questions drive the potential and the eagerness to innovate, outpace rivals and avoid the risk of substitution by other specialized banks. In this context, each universal bank has an internal capital market that allows it to enter into new businesses with some financial clout. The specialised bank, on the other hand, enjoys the advantage of flexibility and cost efficiency.

What conclusions can be drawn from this account of the advantages of universal banks compared with those of specialised banks? It is impossible to derive any general rules that banks could apply to their own growth. However, every bank has a history and possesses certain resources and capabilities within a particular organizational architecture. The functions that a bank can perform and its market positioning are determined not only by a clear corporate intent, but also by the stock of resources or capabilities that the bank possesses or is able to develop or acquire.

4. From Banks' Scope to Banks' Resources

The experience of many diversified firms over the past 15 years has shown that it is not the diversified company itself that competes in each market; it is the individual business unit that competes with the business units of rival companies. A business unit has a sustainable position in a given market when it possesses a competitive advantage over its rivals.

Sustainable economic performance depends on the stock of resources and capabilities that a firm has accumulated. These resources and capabilities are the main drivers of performance.

Firms do not differ only in terms of economic performance; they also differ in performance, because there are important differences between the stocks of resources and capabilities that each firm has accumulated. The heterogeneity of the services available (or potentially available) from the firm's resources gives the firm its unique character.

The resource-based approach to strategy explains superior economic performance not in terms of industry attractiveness or a firm's ability to fix consistently higher prices, but in terms of the resources and capabilities that make it possible for a company to offer lower prices, higher quality, or both. Resources are valuable insofar as they are scarce, untradeable, show externalities and complementarities with other products or resources, and are difficult to imitate and have no substitute.

However, a stock of resources is not enough in itself to generate superior economic performance. History shows that firms with formidable resources –capital or technology– have been unable to compete successfully with other apparently less well endowed companies. There are recent examples in various industries, such as personal computers, copiers or information services, to confirm this.

While we are on this point, it is interesting to note that many business diversification decisions end in failure not so much because the financial estimates for the investment projects are incorrect but because the company lacks the skills and capabilitites to implement them (for example, the necessary technology, or access to distribution channels).

Therefore, it is always wise for a universal bank to consider what resources and capabilities it has that will enable it to compete in a particular segment of the banking industry, or to put it another way, what sustainable competitive advantage it can develop against other more specialised companies that compete in the same segment.

A key question is in which activities a bank has a core competence or undoubted expertise, compared with other banks. If this expertise is inferior to that of its competitors, the bank should find out whether it can acquire expertise through internal development within a reasonable period of time or through an alliance with another bank. If neither is possible, the bank would probably do well to forget about engaging in activities that require skills which it cannot acquire.

A thorough examination of the bank's resources and skills in each of the activities of the value chain may also bring to light opportunities for differentiation vis-à-vis other competing banks. It is crucial that banks look beyond markets and products to see the underlying resources and capabilities.

Let us consider, for instance, marketing capability. This is a tremendously useful weapon, not only for traditional banking operations on the liabilities side, such as new deposit accounts, but also for developing similar new financial products –such as pension funds or investment funds– and marketing them efficiently. In this case, the bank's capability is not only the marketing of deposits, but also the marketing of a wide range of products aimed at savings.

One of the basic tasks of the bank group's management is to encourage and profit from the interrelationships between activities that can be shared among business units, such as the marketing of wealth accumulation products. Experience shows that this is one of the best ways of identifying and realising synergies between business units in the same group.

In fact, as we shall discuss later, a universal bank group's management must justify its very existence by the value it adds to each of the various business units, whether by managing, coordinating or advising. This benefit should offset the additional cost incurred by having a corporate center for the entire group. One procedure for adding value consists of designing the necessary mechanisms for effectively profiting from all the possible interrelationships between the different business units.

In other words, we have started by saying that the existence of a universal bank is justified only if the bank has the resources and capabilities to carry out the various banking activities at least as effectively as a specialist. Otherwise, it may well be in the best interests of everyone (employees, customers and shareholders) to separate out the various business units.

What emerges from this discussion is a fundamental message for the managers of universal banks: move from the concept of generic, integrated banking activities to thinking about functions that will define the basic repositioning and scope of a bank. Any positioning is based on internal resources and capabilities, and only by building, strengthening and stretching these resources and capabilities can a bank successfully sustain a competitive positioning in its markets.

The ability to manage resources also requires a special organizational architecture, without which it will be difficult for managers to think systematically about this process. In the late 1960s, universal banks moved away from a functional organization –in which each basic function was assigned to a separate department– towards a divisional structure, in which each division had resources to deploy in certain markets. Divisions shared common assets, such as information systems or the bank's brand name, but coordination between the units was not very intense. Cooperation was imposed from the top. The divisional structure still predominates among universal banks. How should banks start to think about new organizational structures?

5. From Resources and Capabilities to New Organizational Configurations

Our discussion in the previous sections suggests not only that the concept of integrated banking is becoming unmanageable and obsolete, but also that the attempt to combine business units within a single universal bank is justifiable only under certain circumstances. Capital markets can evaluate business groups using a simple financial principle: the group has a clear *raison d'être* when the market value of the group as a whole exceeds the sum of the individual values of each of its business units. If the latter is the case, then the group clearly adds value to each business unit, and the integrated group makes sense.

The rules for evaluating a financial group's strategic positioning and prospects are clear. However, there are no such clear criteria for designing the right organizational form for a universal bank. The drawback is that structure follows strategy, but a good strategy with a bad organization will not have much chance of success.

The divisional model

The solutions to the organizational design problems of universal banks vary, depending on the degree of autonomy given to each business unit and the role of the group's corporate center. A first solution consists of turning each business unit into a division within the group, with its own management team reporting directly to the group's CEO. The group management retains certain tasks, such as the allocation of financial resources, the corporate brand image, or the purchase and administration of the information systems used by all of the business units.

Historically, this type of divisional model first appeared in some large American companies at the beginning of this century in response to the problems that the functional structure was causing in large and complex companies such as General Motors, Sears or DuPont. This organizational transformation had such a profound impact on the efficiency of these organizations that it has been rated as one of the most important innovations of the century (4).

These companies underwent a major decentralization process, forming divisional units. The company's corporate headquarters retained a few basic tasks, which basically consisted of corporate strategy, coordination between divisions, the organization of the company as a whole, the allocation of financial resources, and the provision of certain central services that were shared by all the divisions.

Owing to the strength of the idea of integration, banks have been slow to adopt the divisional model. The transformation is currently under way in many European universal banks. For example, the investment companies or insurance companies in banks such as Barclays or Banque Nationale de Paris are becoming divisions with a certain degree of autonomy within the group, with a mission statement and specific resources of their own.

In many banks the same autonomy is being given to the management of information systems. These tasks are being grouped in a separate division that delivers services to the rest of the group. In fact, if this division is not competitive enough, banks will eventually get rid of it and subcontract data processing services to outside companies, as is already happening in many countries.

The divisional model in universal banking has some of the advantages associated with this type of structure in multiproduct industrial companies: it enables the bank to break down the different services it offers into individual components, going from the complexity of trying to combine businesses to the simplicity of considering each business unit in its own right, with its own people, resources, products and customers. And this is the first step towards determining whether a particular business unit possesses significant and sustainable advantages over its competitors.

However, in addition to its classic advantages, the divisional model has a number of problems, such as the relative isolation of each divisional unit and the lack of coordination between units. This is particularly serious when the customers targeted by the different divisions are the same or closely related. Another critical issue in divisional firms is the setting of internal transfer prices for the services provided by divisional units to each other or to corporate management.

This is particularly important in the case of universal banks, as they consist of a number of different businesses that share all of the bank's resources. Increasing rivalry and scarcity of resources will make it necessary to allocate assets and resources among the business units and the activities carried out by the universal bank's corporate management, especially those resources that are shared by all of the group's units, such as the group's brand image or the investment in information systems.

The confederated model

A more recently formulated organizational model for banking groups consists not only of dividing the universal bank into separate business units, but of turning these units into legally and financially independent companies; in other words, turning the group into a confederation of companies.

The creation of legally separate companies grouped under a corporate headquarters which coordinates and allocates resources is becoming common in the banking industry. The main reason for this is that some of the new financial services (such as financial derivatives) can only be provided with the necessary quality by a unit that has specialized employees and the necessary resources. That unit needs a high degree of independence from the rest of the bank, which normally tends to revolve around the commercial bank structure and the branch network.

A federated bank needs a number of basic cohesive elements to enable it to reap the benefits of decentralization without leading to lack of focus. These elements, termed by some authors federalist principles (5), seek to articulate the group's philosophy. Banc One is a good example of a federated bank. Its organization rests on the following principles, among others. First, the principle of the separation of power, functions and rights between corporate headquarters and each individual unit. Second, the principle of subsidiarity, which means that each banking unit should decide on all matters in which it is most efficient; in particular, decision-making power should be exercised as close to the customer as possible. Third, the principle of independence between corporate headquarters and units; this principle seeks to avoid domination of one side by the other and tries to establish a balance of power. Although this type of federated form is still not widespread, many banks are drawing closer to it –by creating units with a greater degree of independence, for example.

This organizational form may be thoroughly justified if the group has grown through mergers and takeovers. In this case, the cost of integrating two different organizations may make it preferable to maintain their legal separateness.

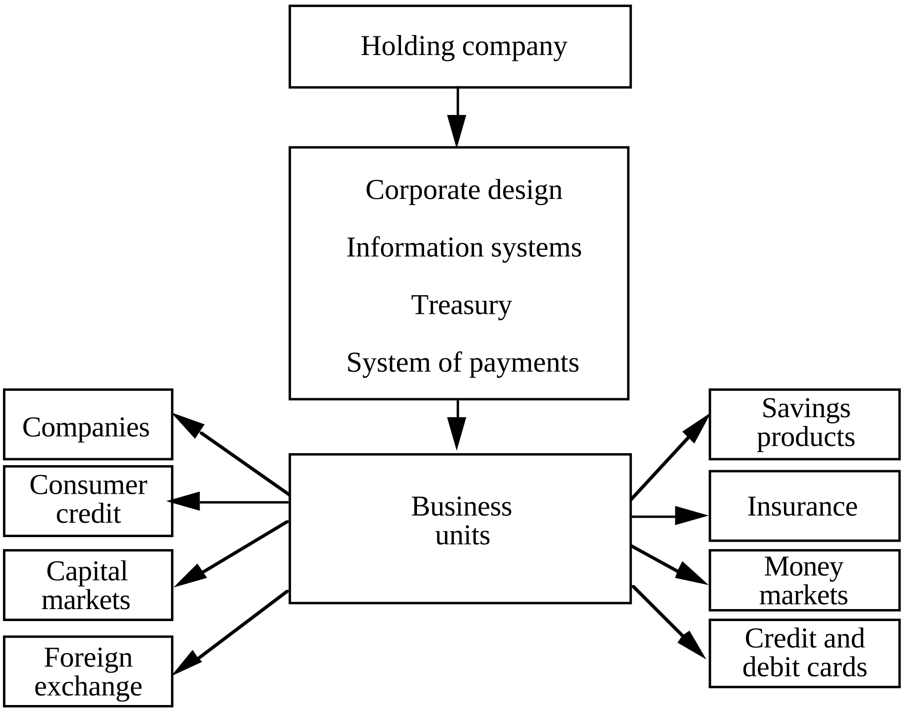
An example is the takeover (and subsequent integration) of Abbey Life, an insurance company, by Lloyds Bank. Lloyds Bank could have entered insurance distribution in a number of ways, but its managers came to the conclusion that a takeover was a quicker and less risky procedure than, for example, internal development.

So as to avoid interfering unduly in the management of the insurance company, Abbey Life has been integrated in the Lloyds Bank group, but with complete management autonomy and a completely different Board of Directors.

However, it would not make much sense to adopt the principle of legally independent companies as a general rule, unless legal considerations or the universal bank's particular culture should so advise. The reason for not considering this formula as a universally applicable recipe is to avoid the costs associated with managing independent banks and to try to capitalise as much as possible on the universal bank's brand image. However, a particular bank may have good reasons of its own (such as a strong commercial banking culture) for deciding to set up legally independent companies.

Figure 2 shows the structure of functions in this type of bank. The configuration is very similar to that of a group of companies or conglomerate, with the particular feature that all the divisions or member companies operate in the financial services industry.

Figure 2. Confederated bank



A comparison between a bank organized in traditional divisions and a federated bank reveals considerable differences. Two in particular should be stressed, as they are the ones that really make the difference between the two types of structure. First, each unit in a federated bank is conceived on the basis of three criteria: a focus on certain types of customer, a definition of the resources to be shared, and the financial performance for which it is accountable. The latter criterion implies introducing the market mechanism to stimulate efficiency within the organization. Second, federated banking reduces the moral hazard associated with deposit insurance, since it separates the (lower risk) retail banking business from the (higher risk) investment banking or capital market business.

None of the organizational solutions described above is ideal for restructuring universal banks and adapting them to the new competitive situation. Each could be implemented with more or less success, depending on the bank group’s history, the dynamics of the industry, the dominant styles and cultures, the resources available and the weight of each business unit.

The role of corporate headquarters

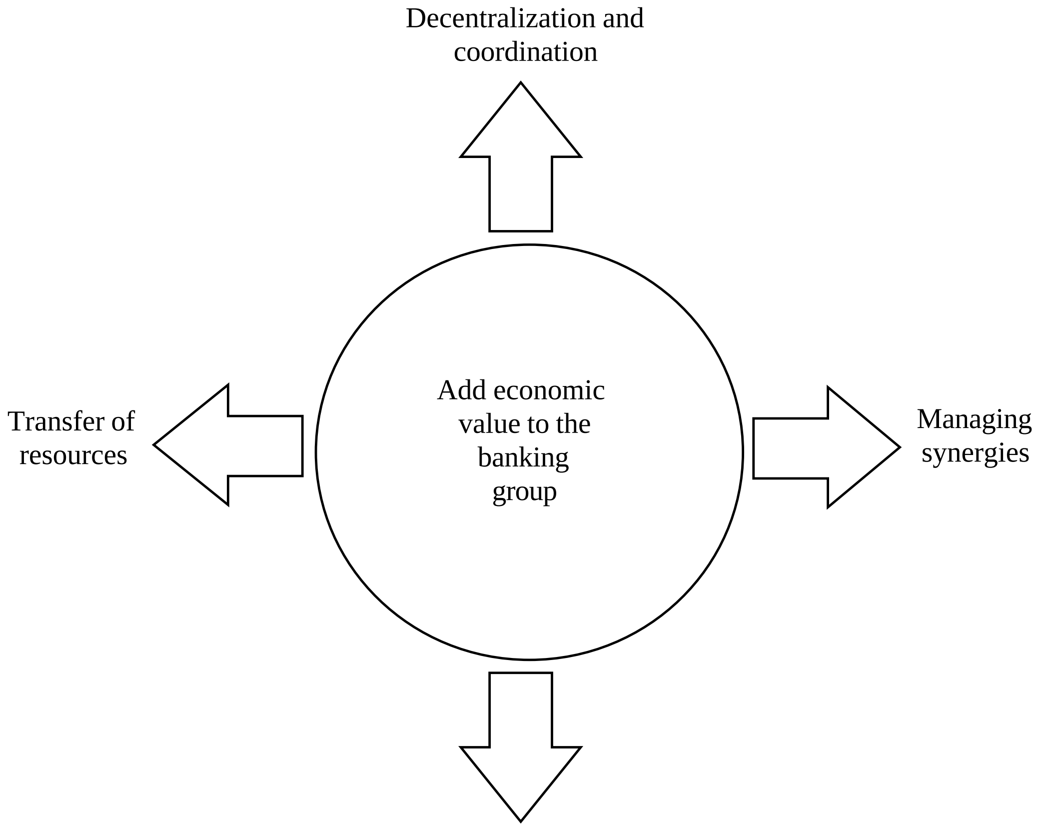
What are the management functions and responsibilities of the bank’s corporate headquarters? This is a hot topic in all large firms. Unfortunately, there are no simple or straightforward answers. This is because the business group’s history, the resources available to it, and the individual features of its member units have a decisive influence on the distribution of functions between the banking group’s center and the divisional units.

In order to better understand the role of the corporate center in a universal bank, we need to reflect on the banking group's corporate strategy. In general, a bank or financial group's strategy should include the following elements: a definition of the various businesses grouped under the corporate umbrella, the competitive positioning of each of those businesses, the consistency of each business unit within the group, the decisions to increase or reduce the scope of the business portfolio, the type of relationship the different business units have with each other and with the bank's headquarters, and finally, the type of organization that best fits the nature of each business unit.

These functions come under the responsibility of the banks' corporate center. Corporate managers have to take on these functions and should add value to the banking group as a whole while performing them.

From our research, we have identified four different corporate patterns that allow the corporate center to make a positive contribution to the business units: decentralization, granting a high degree of autonomy to the individual units; the search for interrelationships or synergies between units; the sharing of functional or interfunctional services between the corporate headquarters and the business units; and, finally, corporate development guided by the parent company's management (See Figure 3).

Figure 3. Universal Banks: The Contribution of Corporate Headquarters



We shall briefly discuss the main features of each of these patterns. The first is decentralization and autonomous management of the business units. Obviously, this autonomy is never complete: once it has appointed key managers and allocated capital, the parent company will probably retain certain rights regarding critical decisions.

However, the main advantage of this approach is that each business unit acts as an independent competitor in its particular segment, with as much operating independence as any other competitor. The parent company contributes management autonomy and recruitment of managers, leaving the market-specific knowledge with the business units' managers.

One example of this type of contribution is found in certain banking groups, especially in the relationship between the commercial banking unit and the investment banking unit, or other different business units. Thus, before it was acquired by Swiss Bank Corporation in 1995, S.G. Warburg set up a separate company to manage investment funds, Mercury Asset Management, in which it had an 85% interest. However, this company's operational management and policies were, for all practical purposes, independent from S.G. Warburg.

The second contribution that a parent company can make to its business units consists of the web of relationships that it can establish with and between the units. These relationships can be extremely varied: human resources policies, transfer prices, development of financial innovations to be shared, or centralized information systems.

An example of a close relationship between the corporate center and the business units is Banc One. Banc One has grown spectacularly in the last 20 years by purchasing smaller regional banks in the US. The policies that Banc One has followed with regard to the banks it has acquired is a clear example of how to develop the sort of web of relationships mentioned above. The first rule is decentralization, at the operational level and in terms of responsibility for performance. Each subsidiary bank has its own Board of Directors, which is responsible for the bank's final results.

However, the subsidiaries share the same brand image; an operations processing system (back office), which is one of the most sophisticated in the US banking industry; a fairly standardized range of financial services, which is designed and passed on from the corporate headquarters to the different units; marketing and distribution policies for these services, with shared resources; and finally, a system called the "Management Information Computer System", which enables each subsidiary to measure its performance against any other Banc One subsidiary that targets the same customers or products in other markets. By this means, each unit is able to monitor its efficiency compared with the other units in the group.

Banc One's business units share common goals that are focused on three indicators: the percentage of customers retained, the turnaround time to customers' requests for service, and the percentage of customers who express their satisfaction with the services offered by the bank. The bank also uses a profitability indicator: net profits over assets. When this indicator equals or exceeds 1.1%, an incentive system for the managers of its subsidiaries starts to operate.

The third potential contribution from the corporate center is more focused on the relationships between the center and the individual units, rather than on relationships between business units. This contribution consists of the influence the corporate headquarters has on the subsidiaries either through the active presence of corporate managers in the different subsidiaries or through services that the group offers them.

In the latter case, the parent company's services may or may not be the same as those described in the second type of contribution. Perhaps the most important difference between these two types of contribution is the involvement of the corporate center in the subsidiaries' decisions. The degree of autonomy, consequently, is slightly less here than in the previous case.

Finally, the fourth potential contribution is related to corporate development, that is, corporate growth by means of investment decisions, entering new businesses, or divesting or exiting businesses that are no longer interesting.

Some diversified companies think that the corporate center has a much better chance of discovering growth opportunities or new businesses than each subsidiary on its own. Also, the corporate center will probably be able to apply financial resources to these new businesses on a scale that the subsidiaries cannot equal.

The contributions described above can be synthesized into a number of general principles that justify the existence of a corporate center in a universal bank. First, the center must create value, or prevent the destruction of value, in the different business units.

Second, in order to create value, the corporate center's resources must be matched to the business units' needs and opportunities, in the knowledge that these can change over time.

Third, the corporate center must show that it makes sense for each individual subsidiary to be part of this particular group, rather than of any other group, by adding greater value to each subsidiary than could be added by any other business group. If it failed to do this, and capital markets were efficient, the group would be broken up.

Fourth, the corporate headquarters must be able to identify ways to spot growth opportunities that will increase the business units' value in the future; and it must contribute to this with at least the same efficiency as other corporate groups.

Fifth, the competitive dynamics of each business unit will be different. The corporate center must concentrate on the units that compete in markets and industries in which the group can contribute a differential value, leaving aside the business units where it cannot easily create value.

In the final analysis, the crucial question in universal banks is how to combine the autonomy that the different banking units need with sufficient coordination to achieve maximum efficiency. The dilemma is not easy to resolve and only an outstanding corporate management will be able to master the complexities of managing a modern universal bank.

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(1) For a review of these changes and their implications, see J. Canals (1993): *Competitive Strategies in European Banking,* Oxford University Press, Oxford.

(2) A formal elaboration of this concept was presented by R. Bryan in "A blueprint for financial reconstruction", *Harvard Business Review,* May-June, 1991.

(3) This concept was elaborated by Robert Merton (1990), "The Financial System and Economic Performance", *Journal of Financial Services Research,* December. D. Crane and Z. Bodie offer a good description of this approach in their article "Form Follows Function: The Transformation of Banking", *Harvard Business Review,* March-April, 1996.

(4) For an excellent summary of these views, see D. Collis and C. Montgomery (1995), "Competing on resources", *Harvard Business Review,* September-October,

(5) See A. Chandler (1962): *Strategy and structure,* MIT Press, Cambridge, MA.

(6) See C. Handy (1992), "Balancing corporate power: A new federalist paper", *Harvard Business Review,* November-December.

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