Banking in the 21st Century: The Transformation of an Industry

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1. Introduction

A central theme of this paper is that, over the next decade and beyond, the banking industry (and financial systems in general) is likely to be subject to a major degree of structural and operational change. Some of the inherent comparative advantages possessed by banks (and which have sustained their dominant position) are being eroded. The pressures impinging on banks have the potential to transform the structure of the industry, the type of business undertaken by banks, the type and range of institutions conducting banking business, and the way that traditional banking business is undertaken. They are also likely to affect the internal structures of the banking firm as banks move towards a structure of *contract banking.*

The objective of the paper is to take an overall view of the banking industry, to pose a series of questions and in particular to focus on two central issues:

- the long run, secular pressures impinging on the industry; and
- the way these pressures may be resolved, in three dimensions – the changing structure of the banking industry, the business operations of banks, and the structure of the banking firm.

2. The Context

The reason why the changes could be so substantial is that there is a powerful combination of pressures operating on the industry, and some of these pressures challenge the very core of banking business: information and delivery. A dominant pressure derives from new technology with respect to information, trading and delivery of financial services. Industrial history shows that the development of new technology can have a major impact on any industry and has often done so. This is most especially the case when technology affects the very core of the business – in the case of banking: information, processing and delivery. In this respect, banking is no different from other industries. It is largely technology, and what follows from it, that will transform the banking and financial services industries.

In many countries, financial systems in general, and the banking sector in particular, are passing through a period of substantial structural change under the combined and inter-related pressures of: internal competition; declining entry barriers; changes in regulation; new information, trading and delivery technology; global competitive pressures; and fast-evolving strategic objectives of banks themselves and their existing and potential competitors. A series of universal trends have become evident all of which have major implications for the competitiveness of banks. The impact of these forces has varied in timing and degree between countries though many of the secular pressures on the industry are universal. A central theme of the paper is that global pressures are likely to dominate country-specific factors in the future evolution of national banking systems.

Banks around the world face formidable challenges: they are losing some of their past monopolies and comparative advantages which have underpinned their dominant position in the financial system. In particular, as entry barriers into banking services are eroded, banks are increasingly facing competition from a wider range of actual and potential suppliers of banking services: the capital markets, money markets, non-banking financial institutions, and also ‘non-financial banking institutions’. In addition, the development of electronic banking has in some countries enabled foreign banks to enter hitherto relatively closed domestic retail banking markets.

In some cases large corporate customers have been internalising some of their banking operations through ‘in-house banks’. In many countries banks are shedding staff and closing branches with the introduction of new technology and alternative delivery systems. At the same time, squeezed by inroads into their traditional businesses and sharper competition, banks are expanding into new areas: insurance, life assurance, unit trusts and other services.

These trends are emerging in the context of major structural changes in financial systems: the relative growth of financial markets; the increasing institutionalisation of saving and investment business; the growing role of institutions in other functions of the financial system (see Davis in this volume); the rise in the role of institutional funds managers in the financial system; diversification of financial firms and the steady erosion of traditional distinctions between different types of financial institution; the entry of new types of supplier of financial services; a substantial growth in the variety of new and complex financial instruments; and the globalisation of financial markets.

3. Are Banks in Decline?

In some respects the role of banks in the financial system is declining and the value of the banking franchise has been eroded. A substantial literature (mainly related to the banking system in the United States) discusses these propositions. The usual evidence cited includes, from the United States:

- the declining share of bank loans in total corporate sector borrowing;
- the shift towards corporate sector borrowing in the commercial paper market (the immediate competitor to banks);
- the loss of corporate lending business to finance companies;
- the declining share of personal sector savings flows directed at banks; and
- the spectacular growth of money market mutual funds.

More general evidence includes:

- the trend towards securitisation in some national and international markets;
- the entry of non-bank financial institutions into traditional banking markets;
- the emergence of a new set of non-financial companies in the markets for retail and wholesale financial services;
- non-banks offering payments facilities; and
- the development of in-house company banks.

Banks are no longer the exclusive suppliers of traditional banking services. An extreme position has been put by Edwards (1993):

> 'An implication of a conclusion that banks have lost much if not all of their specialness is that banks ... no longer have a natural competitive advantage ... If our financial markets and institutions were being created for the first time in the 1990s banks might not be among the surviving institutions.'

The debate about banks possibly being in secular decline is more evident in the United States than in other countries. In some European countries, for instance, banks have been more protected through a legacy of regulation which has restricted competition; the capital market is less developed than in the United States, and entry barriers have been more powerful. Bisignano (1990) notes a more tolerant attitude in some European countries towards cartels and regulation which has restricted competition: 'Informal cartel arrangements, in some cases promoted by government regulations, provided stability at the cost of some inefficiency, borne largely by the retail banking customer'. In Japan, banks have to some extent been protected by the close relationship they hold with their large corporate customers.

However, regulatory approaches are changing and universally regulation has become less protective of banks as public policy priorities have shifted towards enhancing efficiency through competition. Thus, while pressures may have been more pronounced in the US banking system, Browne (1992) cites international evidence that banks are losing market share in lending business. Further, the pressures towards something of a secular decline of banks may have been concealed during the 1980s due to the stock-adjustment impact of deregulation (Benink and Llewellyn 1994). As noted also by Tease and Wilkinson (1993): 'One can characterise the financial deregulation of the 1980s as having both income – from the expansion in demand for financial services – and substitution – from heightened competition – effects on banks'.

However, great care is needed when translating the banks' loss of share in lending business (particularly to the corporate sector) to the more general notion that banking as an industry, and banks as firms, are in secular decline. The two are synonymous only to the extent that:

- the role of banks in financial intermediation is measured in terms of the volume of assets on the balance sheet; and
- banks do not compensate for the loss of some business by diversifying into other areas.

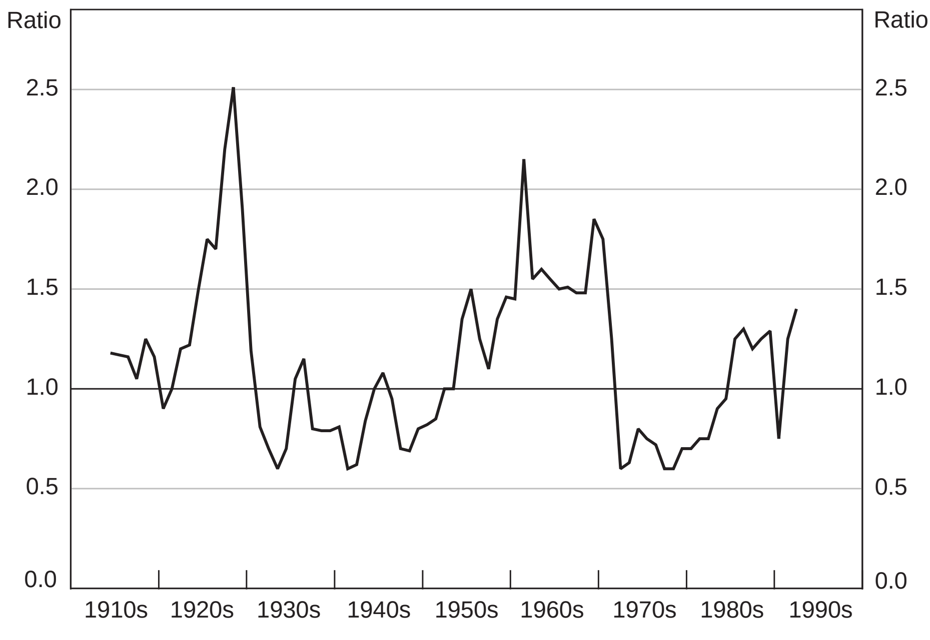
A central theme to be developed in later sections is that banks have certain core competencies or market advantages (for example, information, risk analysis, and so on) and that these can be used in a variety of different ways amongst which making loans and holding them as assets on the balance sheet is only one. The key to developing effective competitive strategies lies in identifying core competencies, making judgments about *how* they can be used, and in selecting the markets in which they can be exploited.

The value added by banks (the ultimate measure of their role in the financial system) is wider than the measure of bank assets. A later section argues that bank loans are in truth a bundled collection of *processes* (origination, risk analysis, administration, and so on) and that banks may supply these component services without holding the ultimate asset on the balance sheet. Thus a different perspective emerges if banks are viewed as suppliers of financial services (including the component processes of loans) rather than as institutions which hold assets on the balance sheet. Focus on the latter exaggerates the declining role of banks.

In fact, even in the United States, data indicate that there is no clear evidence of banks being in secular decline when the focus is value-added, and when allowance is made for diversification into new business, much of which is off the balance sheet. Boyd and Gertler (1994) make adjustments to balance-sheet data to account for the different risk characteristics of different types of bank assets, and apply national income accounts data to the measurement of value added by banks. They conclude that there is no unambiguous evidence that banks are in decline in the United States. Similar conclusions are found in Kaufman and Mote (1994).

In a different way, Saunders (1996) seeks evidence for secular decline in terms of the stock market valuation of banks by observing the ratio of the market value (MVE) to book value (BVE) of the equity capital of banks (Figure 1). If the ratio exceeds unity and is rising, this indicates that the market's judgment is that profitability will be growing. This seems to have been the case through the 1980s and 1990s. However, this result is somewhat ambiguous because it reflects the market valuation after a series of adjustments have been made in the banking industry: including a massive reduction in the number of banks; considerable consolidation of the branch network and infrastructure; increased securitisation of assets; and diversification. Stock market data may simply reflect that banks have successfully *adapted* to secular decline pressures in their traditional business and do not deny that the pressures are substantial.

Figure 1: US Bank Average Ratio of Market Value to Book Value



Source: Saunders (1996).

4. The Banking Firm

Two essential characteristics distinguish the banking firm. In the first place, they issue money-certain liabilities on one side of the balance sheet which are used to fund money-uncertain and non-marketable assets on the other side. The key characteristic of a bank is its role in asset transformation. Secondly, bank liabilities are highly liquid and can be withdrawn on demand. This creates a potential vulnerability in that, if there is a bank run, a solvent bank can be made insolvent because its assets are not marketable. This in turn is because the value of a bank's assets is based on inside information possessed by the bank which cannot credibly be transferred to a secondary market.

As with any firms, banks exist for one of two generic reasons:

- they may have a particular expertise enabling them to do what other firms cannot do – they possess certain monopoly powers; and
- they do what technically can be done by others but they possess certain comparative advantages which give them an advantage in the market place.

It follows that any firm becomes potentially vulnerable if it loses a monopoly power (that is, others become able to do what was previously the exclusive preserve of the firm(s) in question), or its comparative advantages are eroded. In some areas of business, banks have historically had monopoly powers and comparative advantages. However, both are now under question in that there is now virtually nothing a bank does which could not be done by markets, non-bank financial firms, or non-financial banking firms.

In the context of the thesis that banks may be in secular decline, two perspectives immediately arise. Firstly, the thesis relates only to the traditional financial intermediation role and if this is in secular decline it does not necessarily mean that banks as firms are in decline, as other aspects of their business may rise in compensation: banks may transform the nature of their business and/or conduct the same business in different ways. Secondly, the question arises as to whether the factors and advantages that give rise to the financial intermediation role of banks can also be of advantage in non-intermediation business. Put another way, banks may have certain and enduring core competencies that are emphasised in the existence literature, focused on the financial intermediation role (information and monitoring advantages and so on) but which can also be applied in other business areas.

4.1 The Vulnerability of Banks

Banks could be said to be potentially or actually vulnerable for six general reasons:

- monopoly powers are being eroded to the extent that alternative suppliers of traditional banking services have emerged;
- banks may be losing some of their comparative advantages in the provision of their traditional services;
- the supply price of financial intermediation may have risen and the lending margin widened;
- alternatively, the costs of alternative suppliers of intermediation services have fallen;

- consumers may value the services of banks less, or their preferences may switch to alternative suppliers; and
- some of the factors that give rise to the existence of banks may themselves have become less powerful – the factors that account for the rationale of banks may have become weaker. This last point is considered in the next section.

4.1.1 Monopoly erosion

In many ways, banks have lost some of their traditional monopolies. In particular, the development of technology has lowered entry barriers as has the process of deregulation. The process of *deconstruction* (considered in further detail below) also means that new suppliers can offer competition to banks because they are no longer required to provide the full range of banking services, or to undertake all of the processes involved in supplying banking services. In addition, consumers now have more information about a wider range of alternatives to bank deposits for holding liquid funds. The development of money market mutual funds, for instance, which sometimes incorporate payments facilities, also challenges the traditional monopoly of banks in the supply of transactions balances.

4.1.2 Comparative advantage erosion

New technology and declining entry barriers have also challenged some of the traditional comparative advantages possessed by banks. In particular, disclosure laws have eroded some of the information advantages traditionally held by banks and the development of unit trusts and money market mutual funds also allow consumers to have diversified portfolios even with relatively small investments. Moreover, the development of credit scoring techniques means that the credit standing of borrowers can be assessed without the necessity of the information derived through an institution maintaining a borrower’s current account.

4.1.3 Own margin

Clearly, if the banks’ supply price of financial intermediation rises (as measured by the interest margin) banks may become relatively less competitive. This may be because they are locked into a traditional cost structure due partly to having invested substantially in a branch network which is no longer the only means of delivering financial services. At the same time, the cost of capital has in general risen for banks partly because the risk profile of banks has tended to deteriorate – due to competitive pressures, for instance. Further, competitive pressures have eroded the ability of banks to engage in cross-subsidy pricing, which in turn implies that previously subsidised parts of the business are less viable to the extent that banks are forced through competition to lower the price of previously subsidising components of the business.

For similar reasons, competition has eroded the endowment profits to the extent that competition is forcing banks to pay a rate of interest on a higher proportion of deposits and the rate of interest paid has moved closer to market levels. The power of competition is evident in the pressure on banks throughout the world to cut costs, by reducing the numbers employed and by closing branches. In other words, banks seem to be under considerable pressure to lower the supply price of financial intermediation and to narrow the lending margin.

4.1.4 Lower costs of alternative suppliers

For the same reason, if the costs of alternative suppliers of traditional banking services have fallen relative to those of banks, banks again become vulnerable. In particular, financial innovation and the power of new technologies have tended to increase the relative competitiveness of the capital market *vis-à-vis* banks, and new delivery technologies have lowered the cost of alternative suppliers of financial services to the extent that they no longer need to develop a full branch network. Further, to the extent that regulatory costs imposed on banks are higher than those imposed on alternative suppliers of some of the services they provided, regulation has the effect of increasing the relative competitiveness of non-bank suppliers of traditional banking services.

4.1.5 Valuation of services

If consumers value the services offered by banks less than in the past, or their preferences shift to alternative suppliers, banks again become vulnerable. It may be, for instance, that the recent poor performance of banks in many countries have eroded some of the reputation advantages traditionally possessed by banks. Borrowers may also choose to have a more diversified structure of debt and to become less dependent on banks for the supply of credit. As financial markets have broadened and deepened, markets increasingly offer a wider choice of facilities than has been the case in the past. This is particularly powerful for corporate borrowers to the extent that competitive pressures in capital markets have become global in nature.

4.2 Existence of Banks

We may also consider the extent to which some of the traditional factors that give rise to the existence of banks may have become less powerful. The traditional theory of the banking firm (the ‘existence’ literature) emphasises eight elements:

- information issues;
- imperfect markets;
- delegated monitoring;
- control;
- the insurance role of banks;
- commitment theories;
- regulatory subsidies; and
- the special role of banks in the payments system.

A number of these are considered below.

4.2.1 Information advantages

Several theoretical approaches to the existence of the banking firm focus upon various information problems, and how banks are able to handle them more efficiently than the capital market and bilateral transactions between savers and borrowers. The information rationale for financial intermediation is that banks can solve *ex ante* (adverse selection) and *ex post* (moral hazard) contracting problems more efficiently than can be done either directly between ultimate borrowers and lenders, or through markets. Several factors are operating in the direction of eroding some of the banks' traditional information advantages *vis-à-vis* alternative suppliers of intermediation services. Firstly, technological developments have reduced the cost of acquiring and accessing information for alternative suppliers. Secondly, rating agencies have developed both to make information more widely available and accessible and to assess information on behalf of potential investors. Thirdly, disclosure laws (most especially in the United States and the United Kingdom) have been extended with the effect that companies now disclose more information. This means that, in some cases, information which was previously a private advantage to the bank has become more of a 'public good'. In each of these ways banks' information advantages have been eroded.

The development of information technology also increases the availability and access to information to alternative institutions other than banks. There is also something of a vicious or virtuous circle: as capital markets become more efficient, firms have a greater incentive to disclose more information in order to get access to capital market facilities. In turn, this increased supply of information also enables the capital market to function more effectively and act as a greater competitor to banks in their traditional lending business. As noted by Bisignano (1990): 'The comparative advantage that banks have in obtaining, and assessing, the creditworthiness of borrowers and of resolving the asymmetric information problems, appears to be declining, primarily in those countries with increasingly sophisticated capital markets'. In various ways, therefore, banks are losing some of their traditional information advantages that have been the core of their comparative advantage.

4.2.2 Imperfect markets

One general theory of the banking firm is that they exist because financial markets are imperfect and incomplete. However, the process of 'spectrum filling' (approaching the Arrow-Debreu state) reduces the number and extent of discontinuities in the range of market instruments. Borrowers now have a wider range of capital market instruments. Van Horne (1985) argues that securitisation and financial innovation lead to complete markets. In addition, new information and trading technology has reduced information and transaction costs in capital markets relative to bank lending costs (Karekan 1987). Technology has also reduced transactions costs in capital markets and, as already noted, has had the effect of reducing information costs and making information more publicly available for the capital markets. In general, the more complete are contracts, the easier they are to securitise, and the process of financial innovation generally has this effect: it enables more complete contracts to be constructed. Overall, market pressures have been eroding the market imperfections and incompleteness which have given rise to the banks' comparative advantage over markets (Eisenbeis 1990).

4.2.3 Delegated monitoring

A major theory of the banking firm is that of delegated monitoring: ultimate lenders choose to delegate monitoring activity to banks. However, along with the increased availability and lower cost of public information, the development of rating agencies also challenges the traditional role of banks as delegated monitors. As noted by Mayer (1994), monitoring can become a fee-based activity rather than an integral part of the bank loan process.

4.2.4 Control theory

Allied to monitoring is the related concept of control. A bank is in a better position to solve moral hazard problems on loan transactions through superior control mechanisms. It is more able to influence control over the behaviour of borrowers than can individuals and (sometimes) the capital market. Firstly, it is able to devise and enforce incentive-compatible contracts by, for instance, demanding an equity stake in the company (common in some countries), by setting conditions on the loan, and by establishing performance clauses for different tranches of a loan. Secondly, it can enforce contracts (and signal that it will always do so) which dispersed lenders often find uneconomic to do. Thirdly, the bank may demand a management stake in the company. Fourthly, it is able to demand collateral which enhances the incentive for the borrower to behave in the interests of the bank. In some ways a bank is able to act as a proxy shareholder even without an equity stake. Widely dispersed shareholdings may be an inefficient way of enforcing contracts. Thus the distinction between debt and equity in the role of control should not be drawn too rigidly. Overall, banks may have lower control and enforcement costs. However, as shareholdings in companies become more concentrated in the hands of a smaller number of large institutional shareholders, they in turn are able to exercise control more effectively. This again challenges one of the banks' traditional comparative advantages.

4.2.5 Insurance theory

Banks also implicitly provide insurance services that insurance companies are unable to provide because the risks do not meet the standard characteristics of explicitly insurable risks: losses being observable by all (no asymmetric information); the absence of moral hazard inducing the insured to behave in a manner that is prejudicial to the interests of the insurer; and the diversifiability of risks.

Lenders face the risk that they may need funds before the maturity of an imperfectly marketable loan. Liquidity needs are unexpected but not highly correlated between transactors. By pooling risks (having a large number of depositors each with uncertain future liquidity needs) the bank is able to predict its own requirement to meet its depositors' liquidity needs. The greater the number of depositors the more predictable is the liquidity requirement and the bank is able to minimise its own holdings of liquid assets to meet this demand. Thus by pooling risks the bank is able to provide liquidity insurance to risk-averse depositors facing private liquidity risks. It is this that enables banks to hold non-marketable assets. As put by Dowd (1996): 'The bank thus transforms imperfectly marketable, longer term assets into fully marketable, short-term liabilities, and in the process provides its debt-holders with insurance against the contingency that they will be caught short by an unexpected liquidity shock'. The development of unit trusts and money market mutual funds has the effect of eroding the banks' traditional advantage as a supplier of liquidity insurance. Consumers who traditionally maintain liquidity in banks are now able to earn a higher rate of return in money market funds and at the same time secure the advantages of liquidity. This is especially the case in those funds which also offer payments facilities.

4.2.6 Regulatory subsidy

A further strand of analysis focuses not upon intrinsic advantages of banks but upon the implicit subsidies they receive through various forms of protective regulation; regulation which limits competition, deposit insurance, implicit lender-of-last-resort facilities and so on. Regulation may accentuate whatever economic advantages banks may possess and may create economic rents for them. There is a powerful strand in the history of regulation based upon the alleged dangers of 'excessive competition' (Llewellyn 1986). Regulation frequently has the effect of limiting competitive pressures and sustaining restrictive practices and cartels. However, the general trend of deregulation means that these protections have been gradually eroded. To the extent that regulation previously sustained excess capacity, the process of deregulation is likely to reveal the extent of such overcapacity. An industrial structure built up in a protected and uncompetitive environment is likely to be unsustainable in more competitive market conditions. In general, regulation has become less protective of the banking industry as public policy priorities have increasingly been given to enhancing competition and efficiency in the financial system.

4.2.7 Payments advantage

Some theories of the banking firm give emphasis to the advantage that banks have because they are an integral part of the payments system. However, banks are losing their monopolies in this sector of the financial system. The development of money market mutual funds and unit trusts with payments facilities offers a challenge to the banks' traditional monopoly in this area. Similarly, the development of credit cards and debit cards erodes this same monopoly, and an increasing proportion of transactions can now be executed without the need for even a temporary stock of funds in a traditional bank account. The development of electronic barter has enormous potential to undermine the banks' traditional monopoly in the payments system. In general, there is a challenge to banks based on a challenge to two traditional assumptions:

- that transactions require money; and
- that only banks can issue money.

Money is a convenient facility as it means that transactors do not need information about the standing of the payer, as would be the case if payments were made through the transfer of other assets. However, technology also facilitates the verification of the standing of transactors: a particular example is the development of smart cards. Information can now be easily stored in such cards which in turn can be issued by a variety of firms other than banks.

4.3 Assessment

In various ways, therefore, the related pressures of competition, deregulation, financial innovation and technology have eroded some of the comparative advantages of banks in their traditional financial intermediation business. In addition, new information and trading technology has reduced information and transactions costs in capital markets relative to bank lending costs (Kareken 1987). Financial innovation and technology (together with the development of rating agencies) are eroding transactions and information costs and market imperfections which have been the basis of banks' efficiency and comparative advantage over capital markets. Van Der Hoeven (1993) also notes that the development of financial markets has offered appreciable improvements in the form of better price formation and versatile risk management.

Regulation to some extent exaggerated the comparative advantages possessed by banks because it created something of a protected market environment. In effect, banks in some countries are losing their predominant role as deposit-takers and lenders to companies. Market pressures are eroding the market imperfections which gave rise to the banks' comparative advantage over intermediation in capital markets (Eisenbeis 1990). Financial innovation and technology are also eroding transactions and information costs and market imperfections which are the basis of financial institutions' efficiency over direct credit markets. In addition, banks' own cost structures (including the cost of capital) may also have eroded some of their comparative advantages. The recent loan-loss experience of banks in many countries suggest that banks are also subject to problems associated with asymmetric information and inefficient monitoring which some models of the banking firm highlight as the banks' potential major comparative advantage.

5. Some Basic Distinctions and Questions

Banks are no longer the monopoly supplier of banking services, but neither are they restricted exclusively to traditional banking business. It is therefore necessary, when considering strategic issues in banking, to make three fundamental distinctions:

- that between the demand for traditional banking services and the position of banks in supplying those services;
- that between these traditional services and the actual business conducted by banks; and
- the fundamental distinction between *industries* and *markets*.

An instructive analogy is found with the history of the stage-coach industry. In the 1860s it would have been correct to predict that the demand for travel services would rise exponentially: the *market* for travel was expanding. But it would have been a mistake to assume that stage coaches (an industry) would continue to be a dominant supplier of the service. Stage-coach companies disappeared not because the demand for travel declined but because new methods of providing travel services emerged. Conversely, it would have been a mistake to assume that stage-coach companies could only provide stage-coach or even travel services. As Wells Fargo demonstrated, the option of redefining the business in a fundamental way was a viable possibility. Indeed, Wells Fargo became most successful and profitable at the time that its traditional business was in decline. The company took a radical, strategic view of the future and was prepared to fundamentally change the nature of its business.

Companies in any industry can become vulnerable in three circumstances, when:

- consumer preferences for products and services change;
- demand shifts away from traditional firms as entry barriers decline and new suppliers become available; or
- consumer preferences change as alternative ways of satisfying demand emerge.

Although the demand for banking services will continue to rise (and probably relative to incomes), this does not in itself mean that institutions called ‘banks’ will automatically be the suppliers of these services. However, neither does it follow that banks in the future will be conducting only the traditional banking business they have conducted in the past.

This leads to the third distinction noted above: between industries and markets. Stage-coach firms declined because they focused on a particular *product* (the stage coach form of travel) rather than the *market* for travel services. They viewed themselves as being in the stage-coach business rather than the travel business: they were product rather than market or customer orientated. Failure to distinguish between *industry* and *markets* can be a major error in strategic planning in any firm.

The essential skill in strategic planning in a changing market, technological and competitive environment is two-fold:

- to identify the firm’s core competencies (how it can add value); and
- to identify which *markets* these core competencies can serve with comparative advantage.

In the United Kingdom, for instance, the retail store Marks & Spencer identified three core competencies as reputation, retailing, and a delivery capacity (its branch network) and judged (successfully) that these could be used to serve markets in a range of retail financial services such as loans and unit trusts. In other words, Marks & Spencer made a decision to use its core competencies in an entirely different market from its traditional business.

5.1 Five Basic Questions

With this preliminary background, five questions are posed.

- Are banks necessary for banking?
- Is banking necessary for banks?
- Is banking a declining industry?
- Are banks declining firms?
- Will the traditional integrated structure of the banking firm survive?

5.1.1 Are banks necessary for banking?

It would appear that the tentative answer to this is ‘No’ in that there is now little that banks do that could not equally be done by markets, non-bank financial institutions or non-financial banking institutions. As entry barriers are eroded a wider range of competitors has emerged: department stores, companies such as GEC, Virgin Atlantic, a range of 'industrial banks', unit trusts and money market funds, telephone companies and so on. Alternative firms can and do provide some traditional banking services. In the United Kingdom, some life assurance companies have recently obtained banking licences and plan to offer a range of deposit and loan services. For instance, the Scottish Widows life assurance mutual offers four savings deposit accounts (including an instant access account). Similarly, the Prudential Corporation plans to offer a branchless deposit and mortgage lending operation by the end of 1996. Also in the United Kingdom, Marks & Spencer has a banking licence and sells a range of financial services and products and also makes general loans to retail customers. Tesco (the retail store) offers limited banking facilities and offers a rate of interest on credit balances substantially higher than banks. The Virgin Group (which is an airline and entertainments retailer) sells a range of financial products and also has declared ambitions to offer some banking services.

Although some traditional banking markets are being invaded by new types of banking firms, in general the newcomers or non-traditional banking firms have tended to concentrate on niche markets and have not threatened the basic intermediation and payments functions offered by banks.

The devising of viable competitive strategies is particularly challenging when it is not clear or certain who *future* competitors will be. The economics and competitive strategies of new entrants are difficult to fathom simply because they are different from incumbents. Competitive challenges also arise when new entrants are competing in a business which is subsidiary to their mainstream but which is a core business of incumbents. The latter consideration may have the effect of raising the contestability of a business in that, because it is not a core business of a new entrant, exit barriers to them may be low.

The implied increase in contestability of banking markets poses serious competitive threats to banks. New firms may enter banking markets but also have the capacity to subsequently exit the market at low cost. Such 'hit and run' competition offers permanently higher competition to incumbents even though the population of competitors may be constantly changing. In other words, low exit barriers for newcomers pose as substantial a competitive threat as do low entry barriers. Thus entry barriers into some banking services have declined and these are combined with low exit barriers to new entrants but high exit barriers for banks themselves. A recent example is the decision of AT&T in the United States to sell its leasing and financial business. As put by the *Financial Times* (5 June 1996): 'this ends one of the most successful forays into finance by a US industrial group'.

5.1.2 Is banking necessary for banks?

Again the answer seems to be 'No' except in the purely tautological sense that 'banking' might be defined as anything that banks do. In principle, banks need not be restricted to 'banking' business any more than Wells Fargo was restricted to stage coaching. Just as insurance companies have diversified into banking, so banks have diversified into insurance. Overall, the traditional distinctions between different types of financial institution have been eroding rapidly and substantially, and even to the extent that it is debatable whether, in a decade's time, there will be clearly recognisable institutions called 'insurance companies', 'banks' and so on.

The question arises as to whether there are any *economic* or *regulatory* limits on the extent to which banks can diversify from their traditional financial business. The dominant trend is that banks have diversified considerably into a wide range of financial services. It remains to be seen whether, on any significant scale, they will diversify into non-financial business. The question also arises as to whether there must be a 'core' banking business to support a wide range of other financial and even non-financial services.

5.1.3 Is banking a declining industry?

A major question is whether, to any significant extent, banking could be said to be a declining industry in that the services provided by banks can be supplied more economically by institutions other than 'banks' and through markets. Historically, industries in some countries have declined because of various factors operating individually or in combination:

- the development of external competition and declining entry barriers (often due to new technology);
- the development of superior technology outside the traditional industry;
- the removal of protective regulation or subsidies;
- a switch in consumer demand away from traditional suppliers; and
- the emergence of alternative ways of demand being satisfied.

Some of these factors which have caused other industries to decline are now recognisable in banking. In three areas in particular, it could be said that banking is to some (albeit limited) extent a declining industry: on-balance sheet, large corporate sector business (where the capital market has become a powerful competitor); standard retail loans (where a process of *secondary securitisation* has developed, for example, with mortgages); and in the payments system.

5.1.4 Are banks declining firms?

This is not the same question as the last. A traditional industry can be in decline but not the firms within it. It clearly depends upon what strategic responses are made and the extent to which existing firms within an industry are able to redefine the nature of their business by diversifying away from areas where traditional advantages are being eroded.

5.1.5 Will the traditional bank structure survive?

The traditional banking firm is vertically integrated in that it itself manufactures and provides the products and services it offers to customers. The concept of *contract banking* challenges this traditional structure. The trend is likely to be in the direction of subcontracting banking services and processes to external specialist companies with the bank being a manager of a set of internal and external contracts. In effect, a bank becomes a broker between the customer and a set of outside contractors whose activities make up the range of banking products and services.

6. Driving Forces

Over the next decade, banking as an industry, and banks as firms, are likely to face substantial structural change. The business of banking, the operation of the banking firm, and the structure of the industry could change radically. This is because of the combination of pressures that the industry is likely to face. It is the *combination* of pressures that is unique and which will transform the banking industry over the next decade. The dominant pressures may be summarised as follows:

- competitive pressures are increasing and coming from a wider range of competitors;
- the finance industry is becoming increasingly globalised;
- entry barriers into banking are declining, and declining faster than exit barriers;
- the potential for *deconstruction* (the unbundling of products and processes with each being supplied separately) allows 'cherry-picking' and lowers entry barriers, as new entrants are not forced to offer the whole service or product;
- competition is operating asymmetrically – banking can be invaded from outside more easily than banks can diversify out of finance;
- changes in regulation and a process of deregulation in particular are continuing;
- information, trading and delivery technology is transforming the industry;
- therefore, a major problem of *excess capacity* is evident, with respect to the number of firms, infrastructure, capital, and technology; and
- cross-subsidies are being eroded.

The evolution of national banking systems and the business of banks in particular countries is always and everywhere influenced by a combination of *country-specific* and *global* pressures. In the years ahead, the relative role of these two sets of forces is likely to change with global pressures becoming more decisive than country-specific factors. This might suggest that differences between national banking systems could become less pronounced.

6.1 Competition

The overwhelming pressure will continue to be increased competition. Contestability in banking has also been raised. Competition is not a new phenomenon in banking. However, three particular aspects to the way competition is evolving give it a new dimension:

- technology is eroding entry barriers and hence banks face pressures from a wider and more diverse range of competitors;
- as a result of deregulation, the regulatory environment has become less protective of the banking industry; and
- competition has increasingly become global in nature.

Banks will face more intense competition on both sides of the balance sheet: for deposits and loans. On the liabilities side, banks in many countries face increased competition from unit trusts, money market funds and life assurance companies. In many countries (the United Kingdom in particular) the proportion of personal sector assets in the form of liquid deposits is decreasing while that in illiquid, longer-term insurance and investment products is rising. In the United Kingdom some major life assurance companies have recently secured banking licenses in order to compete for traditional deposits.

There is now a wider range of substitutes for bank deposits. Browne (1992) notes that 'financial innovation has now provided savers with greater flexibility in managing their portfolios by enhancing the available instrument choice, and by making existing instruments more accessible'. Consumers also have more choice and are able to accept some asymmetric information risks in return for a higher interest rate whereas historically they have, to some extent, been locked in to bank deposits. Financial innovation, and the creation of new instruments, also enable risks to be hedged. Put another way, part of the return to intermediation has now been appropriated directly by the saver rather than by deposit-taking intermediaries.

It is partly because of these trends that banks in some countries now offer unit trust facilities within the group so that deposits lost by the bank are not lost to the group. In effect, an original process of disintermediation (depositors at banks switching to markets) has been followed by a countervailing process of *re*-intermediation as banks have come themselves to offer market instruments for investors. On the assets side, competition for loan business comes from capital and money markets and other institutions.

6.2 Globalisation

Competition has also increasingly become global in nature, in three respects:

- some customer groups have global financing options and are able to arbitrage between domestic, foreign, and international banks and capital markets;
- banks are not restricted to business within their own country; and
- as a result of regulatory entry barriers having declined, it has become easier for banks to locate in foreign countries.

Banks and financial markets face increasing competitive pressures emanating from a global financial system: the geographical domain in which competition operates has widened. National banking systems are increasingly in competition with each other as national financial systems effectively become subsets of a global system. This has a tendency to equalise the price of some banking services, to compete away relative inefficiencies and monopoly profits that might exist between different national systems, and to some extent to reduce the extent of differences between national systems.

6.3 Entry Barriers

Competitive pressures intensify most powerfully when competition develops from outside the traditional industry as entry barriers decline. This is partly because new entrants often have different cost structures, are less bound by fixed costs, and are often more prepared to challenge traditional industry practices. Both *innocent* (for example, scale economies) and *strategic* (for example, cartels) entry barriers into banking will continue to decline. Technology is eroding some traditional *innocent* entry barriers (such as scale factors and the requirement for a branch network for the delivery of financial services), and competition and changes in regulation are eroding some traditional *strategic* entry barriers (such as restrictive practices, cartels and anti-competitive mechanisms).

6.4 Deconstruction

A further feature reducing entry barriers is the process of *deconstruction*. This involves the process of decomposing services into their component parts which may then be provided separately. These need not be undertaken by the same firm and if, for any reason, different firms have different comparative advantages in different parts of the process, the logical development is for each process to be supplied separately by the firm which has a comparative advantage in doing so. Firms which have an efficient capability for originating and administering loans (for example, because they have a branch network) may not necessarily be the most efficient at holding assets on the balance sheet. Similarly, in the United Kingdom and United States, credit card companies are subcontracting the administration of their business to outside organisations.

Another example is the process of *securitisation* of bank loans: a bank makes a loan, temporarily holds it on the balance sheet, but subsequently securitises it on the capital market. Equally, in some cases the monitoring of borrowers may be undertaken by rating agencies: monitoring does not have to be part of the credit process although this usually is the case with bank loans. As noted by Joss (in this volume), banks are increasingly looking at core elements of their business on a stand-alone basis rather than as necessarily part of an integrated business.

This process of *deconstruction* (or unbundling) effectively lowers entry barriers as it means that new organisations are able to enter a market because they need not be involved with the whole process: they are able to concentrate on that part of a business where they have a comparative advantage. New entrants often target niche markets. This is also related to the question of economies of scale. The major economies of scale in banking relate not to *institutions* but to *processes* and *functions*. In general, specialist providers tend to be more efficient than others.

One of the major pressures in the banking industry in the years ahead will be the deconstruction process where each institution concentrates on that part of the business and those processes in which it has a comparative and competitive advantage. In a similar way, developments in the application of options and asset pricing theory, securitisation, and the evolution of contingent claims and guarantees, have also led to a *deconstruction* of the services traditionally provided by banks into their constituent components. Some of these services can now feasibly be provided more efficiently in the capital market. For instance, the general development of 'pass-through' securities and securitisation in general has resulted in a segmentation of the origination, servicing, credit-evolution, and pricing of credit risk from the credit intermediation function.

6.5 Asymmetric Competition

Competition has a powerful impact on any industry. However, to some extent, competition works asymmetrically in the finance industry: developments in technology, and the general erosion of entry barriers into banking, mean that it is easier for non-bank financial institutions and non-financial institutions to diversify into banking than it is for banks to diversify out of financial services. Thus, while in the United Kingdom, Marks & Spencer (a retail store) offers a range of financial services (including loans), Barclays Bank does not sell men's and women's clothes and frozen food. Similarly, a subsidiary of British Petroleum has a banking licence but National Westminster Bank does not drill for oil.

As entry and regulatory barriers are eroded banks are likely to face competition from a wider range of competitors. Several examples in many countries can be cited where new entrants have been able to compete with banks in supplying some traditional banking services. In-house banks such as Volvo in Sweden, British Petroleum in the United Kingdom, and Renault in France, have all been able to internalise some of their banking operations and, to some extent, provide a limited range of banking services to others. Some large corporate customers have become more creditworthy, and have a higher credit rating, than their bankers, in which case it is not surprising that they both displace banks and to some extent offer banking services to others. Two of the largest corporate lenders in the United States are the General Electric Company and the Ford Motor Company. In some countries, car manufacturers have acquired their own banks for the provision of credit to sales agents. In the United States, industrial and transportation companies, manufacturers and retailers have acquired insurance companies, finance companies and leasing operations; General Motors and IBM offer short-term money market facilities and commercial loans to companies. The largest issuer of credit cards in the United States is a brokerage house, Dean Witter.

And yet to date, the extent to which banks have diversified outside of finance is very limited. This is partly due to regulation which often limits the ability of banks to diversify out of finance more than the ability of non-financial companies to diversify into banking and financial services. The significance of the partly asymmetric nature of competition is that banks are impeded in their strategy of extending the scope of the banking franchise in response to its declining value in traditional markets and business areas.

6.6 Regulation

Almost always and everywhere regulation has the potential to create and sustain *economic rents* and protection. This protection frequently leads to increased costs, buoyant profits, and excess capacity. Historically, regulation in banking has been protective and has often had the effect of limiting balance-sheet growth and the allowable range of business that banks can undertake. It has also had the effect of limiting competition on the premise that 'excessive competition' in banking can lead to increased risk and potential systemic hazards. Regulation in banking has often condoned restrictive practices and anti-competitive devices, and has in general had the effect of limiting price competition. In turn, profits in this regulated industry have been reasonably assured; there has been a high value attached to the banking franchise, and risks in banking have been comparatively low as various forms of credit-rationing have been the norm. At the same time, costs tended to rise to exploit the economic rents created by a protective environment, and non-price competition has dominated price competition. This in turn has created an excessive cost structure. All of this created incipient excess capacity that was viable while the protection lasted but proved to be unsustainable in the absence of that protection.

The universal trend is that public policy priorities have shifted towards enhancing banking efficiency through competition, and in the process public policy has become less protective of the banking industry. As competition in banking becomes increasingly globalised, the ability of individual countries to stand aside from this general trend is strictly limited.

6.7 Technology

The power of technology will be, and has been, particularly decisive: it acts as both a threat and an opportunity to banks. It enables existing services to be provided more efficiently, it enables new services to be offered, it lowers entry barriers in some areas, and it changes the economics of delivery. This is not surprising in that technology has the power to transform the fundamental economics of any industry. In this respect banking is no different from other industries which have been transformed by technology. Technology has the potential to increase the availability and reduce the cost of information. This is a potentially powerful force as it both reinforces and challenges one of the banks' major core competencies: information. This is discussed further in a later section. Given that banks are ultimately in the 'information business', anything that affects the availability, cost and management of information must have a decisive influence on their business. A combination of new technology, the increasing role and power of rating agencies, and more extensive disclosure laws are eroding some of the banks' traditional information advantages. In some cases, information that was previously a private advantage to banks has become more of a public good.

6.8 Excess Capacity

If entry barriers are declining faster and more substantially than exit barriers, it is almost inevitable that excess capacity will emerge. However, the existence of excess capacity in an industry does not mean that new firms will not enter. If new entrants believe they have a competitive advantage *vis-à-vis* incumbents, it may still be rational to enter an industry which has excess capacity. In some areas this has occurred in financial services. The corollary is that there is more pressure on incumbents to adjust. The manner in which excess capacity is removed in the banking industry will be one of the major strategic issues that banks will face in the decade ahead. Compared with other industries, the concept of 'excess capacity' is more difficult to define and measure in banking. Four alternative concepts can be identified.

6.8.1 Excess capital

There is almost certainly an excessive volume of capital in the global banking industry in that, given the market and competitive conditions, it is unlikely that the required rate of return on capital can be earned in the long run. It may be that the market is not big enough to support the current volume of embedded capital in the banking industry. The total volume of capital could be excessive for two reasons: firstly, regulation imposes an unsustainable capital requirement; and/or secondly, the business environment has changed in a way that means that the industry as currently structured, and the amount of business it is able to conduct, can no longer support current capital levels. This may be because new firms have entered or because demand has shifted away from banks (for example, switched to the capital market).

Excess capital (capital in excess of what is needed to support the current or expected level of assets) raises the required rate of return on assets in order to service the capital base. However, the same competitive conditions that have caused banks to lose some lending business also make it difficult to increase the rate of return on assets. Faced with excess capital, a bank has three broad strategic options:

- expand the balance sheet, perhaps by making more risky loans, which may lead to the erosion of lending margins and, if this induces banks to make loans without incorporating the true risk premium, in the end to a destruction of capital;
- make an acquisition (for example, purchase an insurance company), although there is ample empirical evidence that banks with excess capital often pay a premium when making acquisitions, making it difficult to subsequently earn a sufficient risk-adjusted rate of return on the investment; or
- repay capital to shareholders.

The last option may be the optimum strategy if regulation limits the extent to which bank capital can be deployed in new business areas – which does not, of course, limit where shareholders can invest externally to the bank. Many banks in the United States, and Barclays Bank in the United Kingdom, have made repayments of equity capital to shareholders. Shareholders have more options to allocate capital externally than banks have internally.

It is possible to have global excess capital in banking even while each individual bank believes it is short of capital. The two are not contradictory. If each individual bank is seeking to increase its share of a declining market, its own capital may be insufficient to support its planned business profile. But in aggregate, banks may have too much capital for the available amount of profitable business. In other words, the sum of individual banks' desired capital may be excessive in terms of the available volume of collective business. Thus there may be excess capital in aggregate even though each bank considers itself to be short of capital, because the planned or targeted volume of business of each bank sums to greater than 100 per cent of what is available.

6.8.2 Too many banks

It is also evident that there are too many individual banking firms, which prevents the exploitation of economies of scale. Although the empirical evidence with respect to economies of scale in bank firms is inconclusive, there are clear economies of scale in bank processes. Banks may merge in order to secure these economies. It is almost certain that there are economies of scale that can be reaped which are being denied by the current structure of the banking industry in many countries.

6.8.3 Excessive infrastructure

A third concept of 'excess capacity' relates to the basic infrastructure and branch network rather than the number of banks *per se.* In many countries the number of branches is excessive with an implicit unnecessary duplication of banking infrastructure: fixed costs and delivery facilities. This excess capacity can be reduced either by individual banks closing their branches or by merging banks and closing overlapping branches. In the 1992 abortive bid by Lloyds Bank for Midland Bank in the United Kingdom, a central argument was the need to rationalise the British banking system (and most especially the duplication of the branch network) and that this could most efficiently be undertaken through the latter route. Reduction of infrastucture has also been a motivation for bank mergers in many other countries. In effect, a co-ordinated strategy can be more effective and involve lower transactions costs than all banks acting unilaterally given that, in some cases, a major benefit from a branch closure can accrue to a competitor which is able to absorb a lost customer base without adding to its own costs. An alternative strategy when faced with excess distribution capacity is to attempt to supply more products and services through it. Faced with excess distribution capacity banks have two broad strategic alternatives: reduce capacity or pass more business through existing capacity. In this respect, there is a close parallel between excess capacity in capital and infrastructure.

6.8.4 Technology capacity

Developments in technology have themselves affected capacity in that new technology vastly increases the capacity of banks to supply services. It is unlikely that, given the economies of scale in new technology, the current number of banks can be sustained, as they cannot all apply new technology to its most economic extent. And yet banks individually will attempt to do so. This is a case of the fallacy of composition – what is viable for an individual bank is not necessarily so for all banks taken together.

6.9 Erosion of Cross-Subsidies

Cross-subsidisation is a common pricing strategy in multi-product firms including banking where, because competitive conditions between different banking markets are not homogeneous, prices of individual 'products' (for example, loans to different types of customer) do not accurately reflect relative costs and risks. Cross-subsidies exist between customers, products and processes. This necessarily implies 'subsidising' and 'subsidised' products, which also presupposes an ability to segment markets. As competition intensifies, however, and particularly as economic or regulatory entry barriers are lowered, it is frequently 'subsidising' markets which are targeted and this erodes the 'excess profits' earned by existing suppliers. This in turn forces a change in pricing strategies which, on the assumption that the cross-subsidisation was designed to raise overall profits, has the effect of eroding aggregate profits. It is partly because banks cross-subsidise parts of their business that new competitors have been able to enter some niche segments of banking business. However, this entry is also likely to erode the banks' ability to sustain cross-subsidies.

In many countries, banks earn significant endowment profits through 'free resources' (reserves and interest-free deposits). These endowment profits have been eroded due to competitive pressures and the deregulation of interest rates, and hence a significant traditional source of profits has become less powerful. Historically, the existence of endowment profits due to banks' access to cheap retail funds has acted as an entry barrier to foreign banks. To the extent that the cost of retail deposits rises towards the level of wholesale funds, the implicit competitive advantages enjoyed by banks with access to retail funds is eroded and foreign banks and new suppliers are able to compete on less disadvantageous terms.

Cross-subsidies within banks are becoming vulnerable both because entry barriers are declining and because of the process of *deconstruction* noted earlier. The general prediction is that, as competition develops (most especially in those countries where competition in banking is more constrained), the potential for banks to engage in cross-subsidising pricing behaviour will be eroded. This would be a further factor eroding overall profitability. The erosion of cross-subsidies has the effect of raising costs on some services, lowering profits, and, for reasons associated with endowment profits, can have the effect of lowering entry barriers.

7. Implications

The central theme so far has been that it is the *combination* of these pressures that is unique, and which is likely to induce major structural change in banking over the next decade to an extent that will transform the banking industry. Major implications are likely to follow from this combination of pressures and in three dimensions in particular:

- for the structure of financial systems in general and banking sectors in particular;
- for the business operations of the banking firm and the way banking business is conducted; and
- for the organisational structure of the banking firm.

These are considered in the following sections. With respect to the structure of financial systems and banking sectors:

- it is likely that banks will continue to lose some of their traditional business on both sides of the balance sheet;
- the relative role of banks in financial intermediation business is likely to decline;
- the structure of the industry will change, with a further concentration into a smaller number of larger firms;
- it is likely that a greater differentiation will emerge between different types of banks: comprehensive financial conglomerates, retail conglomerates, core-cluster institutions, specialist institutions and so on. The industry could become less homogeneous as different strategies are adopted. As different banks adopt differentiated strategies, a major issue in the future evolution of banking systems will be the conflict between specialist and conglomerate banks;
- the capital market will become a more significant source of funds for the corporate sector as companies bypass banks (*primary securitisation*) and banks will securitise a larger proportion of their retail loans (*secondary securitisation*). The latter

enhances the liquidity of the balance sheet and effectively creates an *ex post* market in bank loans;

- more institutions other than banks will provide basic banking services; and
- institutional investors will have an increased role in the savings and investment process.

7.1 Capital Markets and Securitisation

In some models, the existence of banks is viewed as an endogenous response to imperfect and incomplete markets (see Section 4.2.2 for a more detailed discussion). In a world of zero transactions costs, complete and symmetrically available information, with a complete set of markets to cover all possible future states, there would be no market role for banks as financial intermediaries (that is, their role in accepting deposits with one set of characteristics and creating assets with a different set). Although these conditions are not met in practice, the process of financial innovation and the creation of a wider range of financial instruments (spectrum filling) has reduced the degree of market imperfections and incompleteness, (Llewellyn 1985, 1992) and the number and extent of discontinuities in the range of market instruments.

In addition, banks' own cost structures (including the cost of capital) may also have eroded some of their comparative advantages. This has been accentuated by the lesser ability (due to increased competition) of banks to cross-subsidise corporate lending business. In addition, the development of financial markets has offered appreciable improvements in the form of better price formation and versatile risk management. The growth of rating agencies has also to some extent challenged the *ex ante* screening and *ex post* monitoring of firms which have traditionally been undertaken by banks.

Thus, banks have been losing some of their traditional advantages *vis-à-vis* the capital market for corporate sector business. In many countries, banks have been losing share in the financing of the corporate sector. It is also the case that very large corporate customers are able to borrow on the capital market more cheaply than the banks themselves. A further factor in the securitisation trend has been the introduction, through financial innovation, of new standardised financial instruments suited for mass trade in secondary markets (Horngren 1990). In addition, there has been the development of new analytical methods for valuing complex contingent claims, particularly the Black-Scholes model in the valuation of options which has contributed to the development of organised markets for standardised options. A further decisive factor has been the rapid development in information technology which has meant that the bundling and unbundling of financial assets into new packages that might be of interest to investors has become feasible for trading in organised secondary markets.

The growing institutionalisation of personal savings and the scale of institutionalised savings has reinforced other factors inducing financial flows through markets rather than banks. Thus the trend towards securitisation has been a product of changes in the market and economic environment, shifts in the relative efficiency of bank and capital market facilities, and capital and profitability constraints on banks. On the other hand, the same process of financial innovation has also eroded the distinction between banking and capital market facilities in several respects: many of the capital market instruments are based upon floating interest rates; banks have become holders of capital market instruments; many instruments (swaps being an obvious example) straddle banking and capital markets, and others – note issuance facilities (NIFs) and revolving underwriting facilities (RUFs) – combine banking and capital market instruments. It is also the case that banks are involved with arranging these facilities for corporate clients and hence it is not business lost entirely.

Banks specialise in providing and holding loans that are not readily marketable. The growth of securitisation implies a potential decline in the demand for services traditionally provided by banks, especially for the corporate sector. Overall, the capital market has become a more formidable competitor to banks and this is likely to develop further in an increasing number of countries.

In effect, banks in some countries are losing their predominant role as deposit-takers and lenders to companies. Joss (in this volume) argues that banks are losing some of their traditional advantages, and that there are whole categories of traditional lending business (such as standardised consumer credit and large corporate loans) that banks are no longer suited to fund. He argues that: ‘It is mostly borrowers with unique, non-standard credit needs that will rely heavily on banks and finance companies for their funding requirements’.

Securitisation does not necessarily pose a serious threat to banks. Two views may be identified: the *Market* and *Banker* schools (Gardener 1986). The former implies a continuing and inexorable decline in the traditional role of banks. More extreme proponents within this school go further and postulate that securitisation marks the potential demise of many kinds of banks altogether as they lose their comparative advantage in exploiting market imperfections. The alternative school argues that securitisation is merely one further step in the development of the modern banking firm, and that banks will continue to adapt and innovate in response to changing market conditions. In particular, banks will participate in the securitisation process by acting as brokers and arrangers. In the process the traditional intermediation role will be displaced by arranging, placing and underwriting business.

In general, a central issue in the future evolution of national financial systems, and the international system, will be growing competition and tension between banks and markets: capital and money markets in particular. Financial innovation has enhanced the relative attractiveness of capital markets for many large corporate borrowers. This does not necessarily imply a loss of business for banks, as banks are involved in the capital market operations of their corporate customers. However, it implies that the way banks earn profits from their corporate customers will shift more towards off-balance sheet business compared with the interest margin on on-balance sheet business.

7.2 Consolidation of Structure

The combined pressures identified earlier are likely to induce a further consolidation into a smaller number of larger banks within the banking industry. The BIS (1992) notes that ‘forces are obliging many banks to consolidate ... whether the competition stems from within the industry or outside it, from other financial intermediaries, open capital markets or even non-financial companies themselves’. A ‘merger movement’ has become a pronounced feature of the US banking industry, which is viewed as a ‘solution’ to excess capacity, poor profitability and a lack of capital – and a means of reducing costs, making more viable the implementation of technology strategies where the economies of scale may be substantial (Frazer 1991). There has also been a marked increase in the number of mergers and acquisitions in banking in EC countries. Major banking mergers have taken place in Austria, Denmark, Italy, Japan, the Netherlands, Norway, Sweden and Spain. There has already been a large reduction in the number of credit institutions in Sweden through mergers and a reduction in the number of co-operative and savings banks. The financial crisis in Scandinavian countries has accelerated the pace of restructuring and consolidation.

Overall, the likely trend in many countries is for a reduction in the number of independent banking units and a concentration into a smaller number of larger units. In Italy, the regulatory authorities have been encouraging bank mergers in order to create stronger and more competitive banking firms and in anticipation of a more competitive market environment.

7.3 Strategic Responses: The Business of Banks

All of this requires successful banks to take a radical approach to strategic planning. The pressures outlined earlier have major potential implications for the type of business conducted by banks and the way business is conducted. This was the second major implication noted earlier of the pressures operating on the banking industry. New analysis and perceptions may be needed about: the nature of the industry; the position and business of the banking firm; the way that banks provide their services; and the range of services offered. In particular, there is a need to distinguish between the fundamentals of banking: what banks actually do; and the way they do it.

The starting point is to identify the fundamentals, or core competencies, of the banking firm, that is, what gives banks competitive advantage. The fundamentals of banking are essentially:

- information advantages;
- risk-analysis expertise;
- monitoring of borrowers and enforcement of loan contracts;
- broking potential (bringing various counterparties together);
- delivery capacity; and
- acting as the core of the payments system which acts as the first point of contact with customers.

Banks' overwhelming advantage is the information they have on their customer base which is obtained through economies of scale, investment in information systems and expertise, and economies of scope or synergies. By managing a customer's account, and through the bank's continuous monitoring of customers, a bank necessarily acquires information that can be used in various ways. Information gained through one part of the business operation can be used in others. One reason, for instance, why banks in Germany have a particularly close relationship with their large corporate customers is the accumulation of information gained by the banks through the continuous monitoring of their customers, and much of this information cannot readily be transferred either to other banks or the capital market. Alternatively, the customer may choose not to make information public for competitive reasons but is willing to share it with its banker on an exclusive basis. In this way the bank gains a monopoly advantage over its competitors including the capital market, most especially in cases where disclosure laws are not very demanding.

Banks are essentially in the ‘information business’. In this regard, banks need to focus on two elements: the gathering, storing and retrieval of *data*, and the transformation of that data into usable *information*. Banks have a great deal of data but there is also enormous potential to transform this into valuable information.

These six elements are the banks’ core competencies. In essence, banks have traditionally used their comparative advantages to specialise in the provision, holding and monitoring of loans that are not readily marketable. However, they can be used in a variety of ways. Thus, information advantages can be used by a bank to make loans, underwrite capital market issues of their customers, conduct broking operations, and can be used as a basis for cross-selling a variety of products and services. They can also be used to signal the creditworthiness of their customers on the capital market. There is no unique way in which core competencies can be used. As noted in an earlier section, the skill in developing competitive strategies in a changing market environment is to identify core competencies and markets in which they can be applied with comparative advantage.

Thus, the question of what is the fundamental business of banks is different from the question of what banks do. The theme is that individual banks need to identify their core competencies, as they will differ from one bank to another. This is the necessary starting point in strategic planning exercises. The above are likely to remain the core competencies of banking firms, even if in some areas they have become less powerful.

While the core competencies may be permanent and enduring, how banks exploit them changes over time and, at any point in time, is influenced by a combination of:

- current technology;
- regulation;
- the power of entry barriers;
- competition; and
- the strategic objectives of potential new competitors.

When formulating business strategies, in an environment when the banking industry is subject to substantial structural change, the bank needs to do four things at the outset:

- define its particular and basic core competencies;
- identify which markets these competencies can effectively service;
- select the range of products and services to offer; and
- define the way that core competencies can be applied.

This may mean taking a view about what business the bank is in. A bank needs to define how its core competencies can be used to competitive advantage and this may be different than in the past. The successful development of corporate strategy is ultimately a question of defining core competencies, and developing alternative ways of exploiting them.

These considerations are likely to alter the business profile of the banking firm:

- while much of what banks currently do will gravitate towards markets (*primary* and *secondary* securitisation), banks will be able to exploit their core competencies (for example, information and risk analysis) to service this process for their customers;
- banks will move yet further in the direction of financial services firms and conglomerates of separate businesses rather than purely financial intermediaries;
- a declining proportion of banks' income will be earned through the net interest margin and from on-balance sheet business;
- a wider range of services will be offered;
- off-balance sheet business will develop further;
- a wider range of delivery channels will be offered to customers;
- new ways will emerge for conducting banking business;
- the internal management of banks will continue to change with increasing emphasis on cost-management strategies, pricing strategies, the sustainability of cross-subsidies, increased emphasis on risk analysis and management, and so on;
- the structure of the banking firm will change – banks will move in the direction of *contract banking* and emphasis will be given to core competencies where banks become managers of internal and external contracts on behalf of their customers; and
- the *virtual bank* will emerge as an alternative to the fully integrated financial firm.

In the face of increasing non-traditional competition, together with the growth in domestic and international capital markets, banks are attempting to diversify and redefine their businesses. The traditional financial intermediation role of banks (most especially with respect to the corporate sector) is likely to become a relatively less important part of the overall business as banks diversify into providing a wider range of services. The universal trend towards *bancassurance* (Borio and Filosa 1995; Llewellyn 1995), where insurance and deposit-taking are mixed within the same firm, is a powerful example of diversification. In turn, this will erode what are in some countries traditional or regulatorily imposed distinctions between the six major sectors of finance: commercial banking, investment banking, securities trading and broking, insurance, and funds management. There has already been a blurring of the distinctions between different types of financial institution in many countries (Borio and Filosa 1995).

Overall, banks will be under constant pressure to manage costs strategically and to seek economies wherever they can be secured. A major issue is how far banks can go in this process without a fundamental re-engineering of the business: this is discussed below in the context of *contract banking*. This in turn has implications for the pricing of bank products and services and the continuing viability of cross-subsidies. The general prediction is that, as competition develops yet further, the potential for banks to engage in cross-subsidising pricing behaviour will be eroded. This would be a further factor eroding overall profitability.

7.3.1 Technology and delivery

A major strategic issue to be addressed by banks is the role of technology in changing the economics of delivering financial services (Howcroft and Lavis 1987). Technology has a major impact on the way banking and financial services are delivered. In particular, it reduces the dependence on the branch network as a core delivery mechanism. In this respect, what historically has been one of the banks' major competitive advantages (the branch network which acted as an entry barrier) may have become one of their most difficult problems as a significant part of a bank's cost structure is determined by its basic infrastructure. With the development of new technology a wide range of alternative delivery mechanisms becomes available and most especially through electronic media: telephone, home banking, interactive television and so on.

The likely future pattern is that banks will develop delivery matrices (Figure 2) with differentiations made both between products and services on the one hand and between different customer groups on the other. Banks will offer choice in delivery. Thus, Figure 2 indicates that a given service will be offered to different customer groups through a range of alternative delivery channels, and that a given customer will also use a range of alternative delivery mechanisms. Choice in delivery will be a key element in successful

Figure 2: Delivery Matrix

		Customer group					
		1	2	3	4	...	N
Product/Service	A	X	●	●	★		★
	B	X	●	▲	■		■
	C	X	X	X	X		X
	D	X	★	■	▲		▲
	⋮						
	N	X	▲	★	▲		■

● X ■★▲ etc are delivery mechanisms.

Examples of customer groups:	Individuals; high-wealth individuals; small firms; medium-sized firms; large firms; governments etc.
Examples of products and services:	Loans; deposits; life assurance; mortgages; payment services etc.
Examples of delivery systems:	Branches; telephone; postal; TV; personal computers.

competitive strategy. However, this is likely to be expensive as, to allow for customer choice, excess capacity may be needed in each delivery mode. This in turn is likely to lead to the explicit charging for different delivery mechanisms.

7.3.2 Further securitisation

Increasingly banks will come to securitise a significant proportion of their assets which will have major implications for their business. Firstly, it implies that fee income will become an increasing proportion of banks' total income relative to margin income. Secondly, it implies that the relative sizes of the capital market and banks in the financing of the corporate sector will shift towards the capital market. Thirdly, it also implies that the liquidity of banks' balance sheets will increase to the extent that they hold securitised assets on the balance sheet. In effect, the securitisation of assets and the banks' holdings of such assets, means that one of the traditional special characteristics of banks (the holding of non-marketable assets) is being challenged. Fourthly, the nature of banking business will change as banks become managers of securitised assets (*Economist* 1992). It may also mean that banks will increasingly operate as originators and packagers of credit risk which are ultimately assumed by others. In some senses, securitisation undermines much of what banks have traditionally been paid for: analysing non-standardised credit and holding them in the form of non-tradeable assets against their own capital.

Securitisation does not mean that banks lose corporate sector business. Large firms will continue to use banks for loans even though they may be able to borrow more cheaply in capital markets, for several reasons:

- maintaining lines of credit with banks acts as an insurance against adverse developments in the capital market;
- it allows borrowers to develop a diversified liability structure;
- bank borrowing acts as a signal to the market of the borrower's creditworthiness and the bank's judgment based on inside information; and
- capital market issues are frequently accompanied by backup lines of bank credit and guarantees.

The further development of securitisation is likely to mean that the role of banks in the process of company financing will change. It also implies that the rate of growth of banks' balance sheets is likely to be considerably lower in the future than in the past. At the same time, the process of securitisation in its various forms means that the traditional rigid distinction between capital-market and bank financing will increasingly become less evident.

In the final analysis, banks exploit their comparative advantages and this can be done in various alternative ways. Securitisation is an example of this. Securitisation means not that banks lose business altogether but that they use their comparative advantages in different ways in the securitisation process: as underwriters; offering parallel loans; credit enhancement; holding assets in securitised form by purchasing the bonds issued by capital market institutions to buy the portfolio of loans from the bank; acting as brokers and arrangers, and so on. The nature of the banks' business changes in the process as does the form of remuneration: fees rather than margin.

Securitisation could lead to a reconfiguration of banking. Even with widespread securitisation the incremental value of banks would largely be preserved. They would originate and service assets, while also processing the attendant risk in order to sustain these activities. Banks would therefore continue to screen and monitor borrowers, design and price financial claims and provide risk-management services.

For these reasons, the relationship between banks and the capital market is both competitive and complementary.

7.3.3 Off-balance sheet business

Banks are able to use their core competencies in a variety of different ways and not only through on-balance sheet loans. There has been a trend in many countries for off-balance sheet business and income to rise as a proportion of banks' total business and income. This trend is likely to continue. There is a powerful parallel between on and off-balance sheet business in two respects: the same basic function and service is being provided, and the same core competence (for example, a bank's information advantage) is being applied. Lewis (1988) shows that this applies to the two major areas of off-balance sheet business: contingent claims (loan commitments, guarantees, swaps and hedge transactions, and investment banking activities) and financial services (loan-related services, trust and advisory services, brokerage and agency services and so on). Thus on and off-balance sheet business are alternative ways of exploiting the same core competencies. For instance, an information advantage can be used either to make on-balance sheet loans (with profit earned through the interest margin) or to offer a guarantee or backup line of credit to a borrower making a capital market issue (with profit earned through fee income).

8. The Paradigm of Contract Banking

The third dimension where the pressures outlined earlier are likely to have a major impact is with respect to the nature and structure of the banking firm. The underlying economics of the banking firm is changing radically. The conventional image of a bank is of a vertically integrated firm providing each of the subcomponents of particular services and products: it provides the whole product or service. As a bank has a range of services and products, the image is of a vertically and horizontally integrated firm. However, the basic economics of the banking firm have already begun to change, and the process is likely to accelerate in the years to come. A two-fold distinction needs to be made: between *delivery* and *manufacture* of banking services, and between the services and products the customer ultimately demands (for example, loans) and the components and processes that go to make up those products and services. Thus, what the customer demands is different from what the bank supplies.

It is instructive to consider industries other than banks because, to some extent, banks are moving towards the model adopted by firms in other industries. Take, for instance, a Jaguar car: a high-performance and quality machine. When a customer buys the car, the appearance is that the Jaguar company presents to the customer an integrated service. In fact, of the many thousands of parts that go into making the car, the Jaguar company itself produces virtually none. Most of what is presented to the customer is a repackaging of products manufactured by other companies, but to the Jaguar company's specification, design requirements and high standards. The reasons for this are obvious and taken for granted: the economies of scale are different in the manufacture of the various component parts, and different suppliers have different comparative advantages and expertise. In other words, for the Jaguar company the transactions costs of combining contracts for the external supply of components are less than the economies of scale that could be derived from Jaguar manufacturing all of the component parts. What the Jaguar company successfully does (the value it adds) is essentially three-fold: it maintains a powerful and successful customer interface; it efficiently manages a complex set of external contracts; and it has a particular expertise in design and assembly.

This process, common in the manufacture of goods, has not been the norm in banking where traditionally the banking firm has offered an integrated service by providing the services, and its components, itself. However, as already noted, the process of *deconstruction* (components of products and services being identified separately) changes this picture. It enables particular subcomponents of products or services to be subcontracted (outsourced) and to be supplied by other firms on a contract basis. Similarly, *deconstruction* enables a bank to provide a particular subcomponent of a service to competitors. Thus, a bank may subcontract the administration of its credit card operation while at the same time exporting to other banks its risk-analysis capacity. The potential exists because the economies of scale in bank processes vary. By subcontracting a particular process, a small bank may be able to buy into economies of scale that it could not achieve itself.

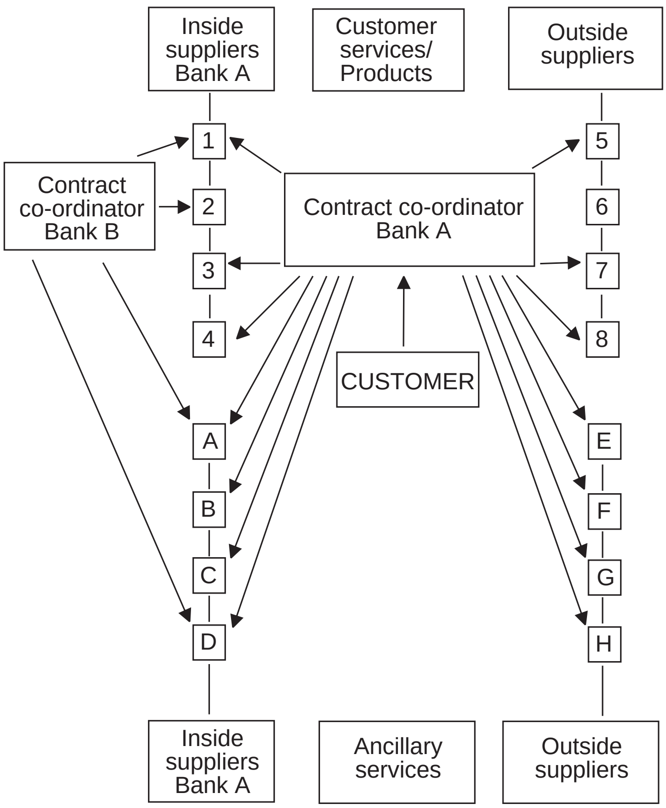
A bank is a complex firm and within it four key roles are distinguished:

- a customer interface and the management of customer relationships;
- the supply of a range of products and services;
- a range of ancillary services (services which are not explicitly demanded by the customer but which are an integral part of what *is* demanded, for example, risk analysis and administration); and
- a supplier of alternative delivery mechanisms.

Thus the banking firm can be viewed as a firm which has an interface with a customer base (supplying a range of apparently integrated products and services) and demanding a series of support services in order to supply the services. Thus, a distinction is made between the final products and services that the customer demands and the various components of that product or service the bank supplies (for example, risk analysis, administration and so on).

The central issue is which of the components are supplied internally, which are subcontracted, and which are exported. Core competencies of particular banks are relevant in this. Thus, what may appear to a customer as an integrated product or service is in fact a series of *deconstructed* components which may or may not be supplied from within the bank. The bank defines the components and decides which are to be supplied internally and which subcontracted. In effect, a series of contracts are established by the contracting bank with internal and external suppliers. This is illustrated in Figure 3. The customer has a demand for a series of products and services (1, 2, 3 and so on) and has a contract with a bank (a contract co-ordinator) to supply those services. The bank in turn has a series of contracts with internal and external suppliers of those services and products (the arrows show the supply of contracts). The subcomponents of these products and services (that is, A, B, C and so on) may also be supplied either internally or externally. Thus Bank A has contracts with internal suppliers of components A, B, C and D, but subcontracts components E, F, G and H. Similarly, Bank B buys in from Bank A products 1 and 2 and components A and D.

Figure 3: Example of a Contract Banking Structure



What might be termed *contract banking* implies a bank offering a full range of services, but where the bank co-ordinates inputs from a wide range of different companies. The core is a contract the bank has with its customers to supply a set of services or products of a particular standard. In turn, the bank contractor has a set of contracts with a range of internal and external suppliers of the components of these ultimate products and services. The value added by the bank contractor is in the management of these contracts.

Various forms of outsourcing are available: third-party processors, service bureaus, and facilities-management contractors. In addition, two or more parties might establish a joint venture to undertake certain activities on a joint basis.

A major form of outsourcing is third-party processing on a line-of-business basis. Those functions that are most automated or specialised tend to be the most outsourced partly because this is where economies of scale potential are greatest. As already noted, developments in information technology have lowered the cost of performing information-intensive activities, providing economies of scale can be reaped. Examples of outsourcing include: mortgage processing, credit card administration, cheque processing, network operations and management, credit card issuance, student loan processing, trust processing, securities safe-keeping, ATM driving/switching, retail lockbox, applications development and management, data centre and balance reporting. As technology becomes more intense and specialised and requires heavy investment, it tends to be disaggregated, that is, technology operations are broken apart and split up amongst a number of highly specialised technology companies which supply similar services to several banks.

There are several reasons why outsourcing is undertaken:

- to reap economies of scale that cannot be attained internally;
- some technology projects last only for a short period;
- some areas may be too specialist to be undertaken internally;
- skills can be enhanced when technologists work on several projects;
- a particular expertise may not be available internally and may be uneconomic to acquire;
- to spread costs and risks; and
- to break an internal monopoly when services are supplied exclusively internally.

The obvious hazard in outsourcing is that the bank may unwittingly introduce its customers to a potential competitor.

If external contracts are made, issues arise about setting performance standards, monitoring standards, and sometimes moral hazard problems when the external supplier has a lesser stake in the outcome than the bank itself. However, these are not different issues from those that arise when internal suppliers are involved. The key question is whether these functions can be performed more efficiently with internal or external contracts. Clearly, the costs of managing external contracts is part of the overall judgment. In some cases the costs of monitoring external contracts, including potential moral hazards, may be prohibitive.

At the same time, some banks may themselves become suppliers of outsourcing services for other banks including their competitors. Thus, if there are significant economies of scale in a particular process a bank can secure these economies in one of four ways: by being big; by outsourcing; by forming joint ventures with others; or by the bank investing in a process and supplying the excess capacity to others. As an example, a bank may decide to establish a cheque-processing facility and to provide the same service to others.

In a competitive market all firms (including banks) are under pressure to gain cost advantages wherever they can be secured. In some cases banks may have gone as far as they can in cutting costs without a more fundamental re-engineering of the business such as is implied in *contract banking*. If technology has the effect of increasing the economies of scale, the issue becomes how banks can reap such economies. As noted, economies can be secured either internally or externally but in some cases it may require a fundamental re-engineering of the bank. However, paradoxically, the technology which increases the economies of scale in bank processes, combined with the ability to deconstruct products and services and have components priced and supplied independently, means that both small and large banks can coexist, and that there will be greater variety in the structure of banking firms. This is because economies of scale are in bank processes rather than in banks *per se*.

Thus, the concept of the fully integrated bank is becoming outdated. In effect, the bank is a ‘manager of contracts’ (internal and external) on behalf of its customers. This involves a new definition of the business of banks and a new way of managing relationships with customers:

- maintaining the customer interface;
- designing products and services;
- setting standards;
- establishing internal and external contracts;
- monitoring suppliers (internal and external contract holders);
- enforcing standards;
- protecting against moral hazard, most especially when contracting with outsiders; and
- creating a set of internal and external incentive-compatible contracts.

The skill is to manage these contracts more effectively and efficiently than alternative suppliers. In this sense, a bank is no different from any other firm.

At its extreme, the possibility of the *virtual bank* emerges. This has an interface with its customers and seemingly supplies a set of integrated services and products. And yet it may do nothing itself other than to manage a set of contracts with external suppliers. It is a contractor of other firms’ products and services and a co-ordinator of a network of contracts and services. It is, in effect, a broker between the customer and the ultimate supplier of services which go to make up the final products and services demanded by the customer. This may mean that comparatively small *virtual banks* can exist side by side with large banks. They may provide the full range of banking services with the customer being unaware that the bank is in truth a network of alliances with specialist providers.

What in practice is likely to emerge is a spectrum of different types of bank. At one end of the spectrum will be the traditional fully integrated bank which, because of the economies of scale in bank processes, will be very large. At the other end of the spectrum lies the *virtual bank*. In practice, the majority are likely to lie within the polar boundaries of the two with some services being provided internally and others outsourced. It is ultimately a question of the balance between internal and external contracts and many alternative structures are likely to emerge. The development of outsourcing does, however, mean that there can be a role for the small bank in a market and technology environment where many banking operations require large scale to be economic. Thus, while there will be a trend towards more consolidation in the banking industry, there will still be a place for the smaller bank, though it will not have the traditional structure.

An implication of much of the analysis of this paper is that banks will be under constant pressure to cut and contain costs as a permanent feature of strategy. The economies of scale to be derived through the application of technology will be one of the routes of this pressure. However, if economies of scale relate predominantly to bank *processes* rather than *institutions*, and external contracts can be managed efficiently, the existence of economies of scale does not mean that only large banks can be competitive and will survive.

Two conflicting pressures are emerging. On the one hand, technology (to the extent that it raises economies of scale) leads to the emergence of large banks and the consolidation of the banking industry. On the other hand, and working against this trend, the process of *deconstruction* and *contract banking* mean that there are alternative ways of securing the competitive advantages of economies of scale.

8.1 Wholesale vs. Retail Business

Throughout the previous analysis *ad hoc* distinctions have been drawn between wholesale and retail banking business. Many of the pressures identified are more evident in wholesale than retail sectors of banking business. In order to formalise the distinction the arguments are summarised in Table 1. While the pressures and outcomes are more

Table 1: Wholesale vs. Retail Banking

Issue	Wholesale	Retail
Internal competition	Intense	Weaker but newcomers important as: • behave differently; • exit barriers low
Entry barriers	Disappearing	Barriers remain in some areas
Exit barriers	Low	High for incumbents but low for newcomers
Regulation	Declining	Increasing
Technology	Advancing rapidly	Advancing rapidly
Competition from non-banks: financial	Increasing rapidly	Rising but limited to selected business areas
Competition from non-banks: non-financial	Increasing rapidly	Rising but limited to selected business areas
Competition from markets	High	Low
Cross-border competition	Intense	Very low
Diversification	Increasing rapidly	Increasing rapidly
Securitisation	High	Low
Contract banking	Will occur	Will occur
Excess capacity	High	Rationalisation but more obstacles
Deconstruction	Developing	Developing
Payments	Challenge of markets	Challenge of markets
Customer loyalty	Low	High because of transactions costs

evident in wholesale business (where competition from markets has been particularly powerful) they are also developing in retail business and the differences are eroding.

9. Assessment

In various ways the related pressures of competition, declining entry barriers, deregulation, financial innovation and technology have eroded some of the comparative advantages of banks in their traditional financial intermediation business. Regulation in the past to some extent exaggerated the comparative advantages of banks because it created something of a protective market environment. Now, because of deregulation, banks in some countries are losing their predominant role as deposit-takers and lenders to companies. Market pressures, financial innovation and technology are eroding transactions and information costs and market imperfections which have been the basis of banks' comparative advantage over direct credit markets. In addition, banks' own cost structures (including the cost of capital) may also have eroded some of their comparative advantages.

Above all, banks are no longer the exclusive suppliers of banking services: there are many traditional activities of banks that can now be undertaken equally well by markets and other types of financial and non-financial companies. In addition, with the exponential development of information, trading and delivery technology, the value-added in the banking business is increasingly passing away from banks to specialist technology companies. Banking used to be about banking firms which used technology to supply services. Perhaps the new model is that it is about technology which has a financial services component!

The overall impact of these factors can be focused in a general proposition: *the value of the banking franchise is being eroded.* For all the reasons discussed, banking markets are less the exclusive preserve of banks. As put by Bisignano (1990): 'With the decline in the franchise value of banks, the banking systems in some countries are shrinking'.

However, this does not necessarily mean a pessimistic outlook for *banking firms* as the business of the banking firm is likely to change towards the provision of a wider range of financial services relative to the traditional financial intermediation and on-balance sheet roles. Banks are not so much in decline as re-creating themselves.

The successful development of corporate strategy is ultimately a question of defining comparative advantages, and developing alternative ways of exploiting such advantages. Thus, while banks may continue to have information advantages with respect to their customers, this does not necessarily mean they are only to be exploited in the form of making loans and/or holding loans on the balance sheet. Information advantages can be exploited in many other ways such as servicing the capital market. While banks may lose market share in some of their traditional markets, they will gain and develop other business and use their core competencies in different ways.

The combination of diversification, *deconstruction* and *contract banking* implies that banks are diversifying horizontally but becoming more specialist vertically. The management challenges to doing this successfully are formidable.

A series of secular pressures on the banking industry has been identified including the impact of declining entry barriers in widening the range of competitors. Two contrasting views may be summarised. At one end of the spectrum is the view that banks are losing their historic comparative advantages and that their role in the financial system is in permanent decline. The alternative polar view is that the pressures are transitory and that many of the new entrants will find that they have no enduring core competencies in financial services. The truth is likely to be within the two polar cases. Banks will continue to be subject to secular pressures which are moving against them. However, they retain powerful core competencies and these can be exploited in new ways and in different markets, thus limiting the extent of any secular decline. However, this may require a radical review of what business banks are in, and how core competencies can be exploited for competitive advantage. It may also require a restructuring of the banking firm.

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