CORPORATE STRATEGY, CENTRALIZATION AND OUTSOURCING IN BANKING: CASE STUDIES ON PAPER PAYMENTS PROCESSING

Prof. Douglas Wood
Manchester Business School
Booth Street West
Manchester, M15 6PB, UK.
Tel: +44 (0) 161 275 6590 Fax: +44 (0) 161 275 6489
Email: d.wood@fs2.mbs.ac.uk

And

Bernardo Bátiz-Lazo
The Queen's University of Belfast
Queen's School of Management
Lanyon Building
Belfast, N.I. BT7 1NN
Tel: +44 (0) 1232 273 791 Fax: +44 (0) 1232 328 649
Email: b.batiz-lazo@qub.ac.uk

ABSTRACT

This is an empirical review of IT outsourcing as an emerging tool for corporate strategy after deregulation and other phenomena challenged the suitability of global/universal bank model. Case studies of UK commercial banks are used to focus on cost management of paper and electronic processing through insourcing and outsourcing arrangements to change the size/efficiency equation in banking. The analysis discusses the corporate strategy and core capability issues behind a number of innovations and illustrates how outsourcing and other third party arrangements alters strategic balance albeit as a component element of overall strategy. The paper establishes why outsourcing decisions have been concentrated in particular aspects of banking and discusses the competitive and environmental forces which have contributed to this focus.

Helpful comments from Ahmad Jumah, Chris Holland, senior executives of UK clearing banks and building societies are gratefully acknowledged. Also, those made anonymous referees of the Eastern Academy of Management-International and participants to the 15th Annual International Conference of The Association of Management. Nevertheless, the usual disclaimers apply. Mr. Bátiz-Lazo was sponsored by Conacyt (Num. 82619). We also thank the travel bursary to the conference from MBS Research Committee. All correspondence to B.Batiz-Lazo@QUB.AC.UK, fax: +44 (0) 1232 328 649.

FORTHCOMMING: ***INTERNATIONAL ASSOCIATION OF MANAGEMENT JOURNAL***

1 INTRODUCTION

In the last 10 years substantial changes in the business environment left commercial banks with longstanding advantages in core processes at a competitive cost disadvantage relative to new competitors. Deregulation opened the most profitable segments of retail financial services to non-bank competitors while IT innovations extended production options to offer cost reductions to both new players and existing banks. Technology challenged integration solutions by giving existing and new competitors a new range of strategies based on insourcing and outsourcing* that redefined supply chains in respect of client capture, distribution or asset securitization. However the impact of these developments was cushioned by the absence of an established market place for outsourcing services. The degree of effective competition in bank markets is therefore difficult to establish without examining bank supply chains from the broader perspective developed and tested for non-financial firms (on the latter see Williamson, 1975:120-125 or Prahalad-Hamel, 1990:84).

In what follows, section 2 presents a brief review of the main theoretical issues and empirical work regarding outsourcing of IT based business processes (transactions processing, information storage retrieval and analysis) in bank markets. The issue is less to do with banks' ability to retain advantageous market positions as their ability to control and reduce the potential costs involved in doing so. The discussion builds upon Holmes-Green (1986), Beaver-Jennings (1996), and Morris-Westbrook (1996) to compare centralisation and outsourcing strategies of British commercial banks. The assessment provides insight into how improved IT/IS capabilities, many of them developed outside the banking system led to efficiency motivated innovation in banking. Detailed case studies of the Co-operative Bank and Midland Bank illustrate two alternative attempts to use new technology to control the costs of processing paper-based transactions. Sections 3 and 4 depict how Midland Bank generally developed in-house solutions while a previously disadvantaged small scale competitor (the Co-operative Bank) mainly utilised the capabilities of external paper-processing vendors. Section 5 extends the discussion to banks in Portugal and the US and presents a discussion of the corporate strategy behind each approach to rebuild scale scope and cost advantages in transactions processing and reviews the relationship between outsourcing and diversification decisions. Section 6 offers a summary and discussion of how the market for outsourcing IT-based banking processes evolved, how competition in bank markets is affected by growing

---

* Defined by Lacity et al. (1996:13) as: "...a contractual relationship through which a user transfers assets, leases, staff and management responsibility for delivery of internal functions to a vendor or group of vendors."

outsource capabilities and how outsourcing decisions have altered strategic balance in ways that have had a major influence on the growth of bank markets.

2 THEORETICAL ISSUES AND EMPIRICAL LIMITATIONS

2.1 Actual and Potential Sources of Conflict

2.1.1 The Design of Ideal Outsourcing Strategies

The current approach towards an outsourcing strategy rests on the seminal contributions of Coase (1937) and Williamson (1975). This approach argues that regardless of installed capacity, a potential user will outsource if the price offered by the vendor is lower than the incremental (avoidable) cost of providing the function in-house. In other words, market transactions replace internal processing where the cost of locating outsource supplies, the cost of negotiating outsource contracts and the costs under the contract fall below the resource and resource allocation (overhead) of internal processing.

Effectively outsourcing vendors are suppliers of intermediate goods. Raw data (or access to raw data) and service parameters are provided by the user with the vendor reselling data processed to contract specifications back to the user. Assuming equal power of negotiation, outsourcing is a zero sum game between the parties unless, as Table 1 outlines the parties can devise efficient contracts offering adequate incentives to support the release of resources. Otherwise, the incompatibility of incentives can become a source of failure for outsourcing contracts however advantageous it is in principle (see Williamson, 1975:124 or evidence presented in Lacity-Hirschheim, 1993).

[Insert table 1 around here]

The issues to be resolved in any outsourcing contract comprise the uniqueness of the investment to be made (asset specificity); the arrangements to resolve problems not covered by the formal agreement (settling disputes); and the frequency of the transaction (see further Williamson, 1975:86ff).

2.1.2 Empirical Evidence on IT Outsourcing Strategies

Evidence presented in Lacity-Hirschheim (1993), Datamonitor (1994), McFarland-Noland (1995), Alexander-Young (1996), O'Heney (1996) and Lacity et al. (1996), among others, supports Williamson's (1975) arguments and suggests four reasons for firms to outsource IT intensive processes. As reflected in table 2, one empirically grounded reason for outsourcing growth was the strategic shift as banks abandoned product and market growth (diversification) strategies to focus on core competencies.

[Insert table 2 around here]

Outsourcing also lowers the risks of innovation by turning fixed possibly uncertain costs into variable costs. In the case of IT based processes many investments failed to deliver the expected competitive advantage (some examples are documented in Morris, 1986). IT expenditure becomes simply a cost of doing business rather than a source of strategic benefit or a source of core competence.

Lack of skills was another empirically grounded explanation behind IT outsourcing in bank markets. The nature and speed of IT innovations and the importance of bank to bank communications gave IT developers who could sell applications to many buyers an advantage relative to banks developing a proprietary system. Also because IT professionals perceived better career opportunities through self-employment or working for international firms like Andersen Consulting or EDS the Co-operative Bank or Continental Bank, through outsourcing, enjoyed access to better quality and more widely experienced staff than they could have attracted into direct employment.

2.1.3 IT Outsourcing in Bank Markets

Empirical evidence in Lacity et al. (1996:14) suggests few outsourcers pursue "total outsourcing" (defined where suppliers provide at least 80% of a specific function's pre-outsourcing budget). Even partial outsourcing of IT intensive processes though offers banks the opportunity to subject difficult to control or non-transparent processes to market testing. In practice a minority of banks did pursue IT outsourcing (see further Jennings, 1996). Empirical evidence, for example in Earl (1996) and Lacity et al. (1996), suggested that banks who might otherwise anticipate that outsourcing would enhance competitiveness or stimulate growth hesitated to outsource because the outsource market was under developed raising concerns about costly negotiations and strategic dependence.

Outsourcing, where it occurred for the most part concentrated on standardised operations. Standardised processes lend themselves to straightforward outsourcing contracts with low transaction cost. Outsourcing the purchase of office supplies, catering and security were examples where banks commonly engaged in low transaction cost outsourcing contracts. Another example of greater relevance was the outsourcing of paper-processing for high volume standard transactions.

The discussion now turns to examine how paper-processing re-engineered through outsourcing influenced the pattern of competitive advantage in bank markets.

2.1.4 Barriers to Enter Bank Markets through Clearing Payments

2.1.5 Brief History

A payment clearing system has existed in London since the 1770s, for much of that time based at the Banker's Clearing House (Bank of England, 1987:392). Here representatives of note-issuing banks met to exchange cheques, to transfer money between accounts at different banks and settle net positions with payments from balances at the Bank of England (among others Perry, 1975:63). A limited liability company known as the Bankers' Clearing House Ltd was established in 1864, owned and controlled by a group of banks (called "The Committee of London Clearing Banks") offering current account facilities and money transmission services as their core business (Cooper, 1984:50). Non-member banks wishing to compete with current account facilities could only do so by outsourcing to one of the “clearing banks”.

By 1900 the ten clearing banks controlled 46% of total deposits in England and Wales and by the end of the first world war, five of these banks held 97% of total deposits (Holmes-Green, 1986:121). Fifty years of stability followed until in 1960 clearing was extended to include credit transfers and standing order payments (Perry, 1975:75) and the clearing banks themselves became involved in major consolidation. Westminster Bank and National and Provincial Bank merged as NatWest, Barclays acquired Martins Bank, and smaller clearing banks merged to create Williams and Glyn's Bank, later absorbed by the Royal Bank of Scotland. Together with Midland Bank and Lloyds Bank these five groups dominated retail and commercial banking in the UK.

Alongside these bank mergers, clearing banks established an electronic payments system (called BACS) which again could only be used by non-clearing banks through a clearing member. The BACS system quickly became the world's largest automated clearing house handling 262 million items in 1976 (Cooper, 1984:53). In 1975 two small banks, The Co-operative Bank and the Trustees Savings Bank whose independence had been preserved by a mutual ownership, also became clearing banks to be joined by National Girobank in 1983 (Bank of England, 1987:392).

2.1.6 Attempts to Change the Membership of the Retail Clearing System

The closed membership of the British retail clearing system attracted official concern in the form of two enquiries, namely "Banks: Charges for Money Transmission Services" (Price Commission, 1978) and "Committee to Review the Functioning of the Financial System" (Wilson Report, 1980). Although these two reports found no evidence that clearing banks had excluded potential entrants the Bank of England, the UK’s central bank (and a clearing bank since 1864) became more active in controlling membership of the Clearing House (Bank of England,

1987:392). A third government report (the Child Report, 1984) written jointly with the banks formally opened membership of the clearing system to all banks (and non-banks) satisfying Bank of England requirements. The report also established a new structure for the payment system comprising a holding company with three main subsidiaries (Bank of England, 1987:393):

- Retail payments (cheque and credit card clearing);
- Wholesale payments (CHAPS or a system for £10,000 pounds and over, same-day settlements);
- Electronic payments (BACS or clearing for direct debits, standing orders and other automated credit transfers).

In addition two operational groups were set up to manage currency clearing for US dollar-based transactions in London and to oversee the operation of the domestic cheque guaranty scheme.

This marked the end of almost a century where access to paper-based transaction processing provided a major entry barrier into the UK banking market. Changed regulation and new technology meant potential entrants could now access payment processing by building their processing capabilities or contracting for them from a clearing banks or other institution. The development of the outsourcing markets. This became a major determinant of the competitive performance of firms competing in bank markets. The discussion that follows explores the degree to which outsource possibilities in scale sensitive processes have influenced contestability in bank markets. The analysis proceeds through a detailed examination of paper payment processing in two British clearing banks.

3 COMPETITIVE POSITIONING OF SELECTED BANKS

3.1 Origins and Growth of the Midland Bank

3.1.1 Rationale for Bank Choice

Midland Bank represents an internal response to the intensification of contestability in paper-based transactions resulting from IT innovation. Automation created large scale based advantages in the settlement of paper-based transactions so Midland, one of the world's largest banks, would see itself as well placed to benefit from the reduced costs and increased barriers to entry provided by investment in in house capability. Managers at Midland Bank therefore pursued a competitive vision, of achieves strategic cost advantage. Although the selected course of action was pursued with some success with Midland transferring high cost branch processing to low cost processing centres this was offset by problems from product and geographic diversification ultimately weakening Midland and making it vulnerable to takeover by Hong Kong based HKSB.

3.1.2 Rise to the Top (1836-1939)

The Midland Bank was established in 1836 and following a period of amalgamation the Birmingham-based bank emerged with the biggest branch network in Britain a position it maintained until after World War II. Midlands size gave it an advantage in foreign-trade finance built upon "correspondent bank" agreements which were established as early as 1898 (Midland, 1992:17). Instead of overseas offices, branches, affiliates or subsidiaries, Midland's concluded a network of agreements with foreign banks to provide a wide range of services in exchange for fees or deposits. 40 arrangements were inherited from City Bank in 1898 growing to 132 by 1908, 850 by 1918, and over 1,200 after 1929 (Holmes-Green, 1986:132).

By 1919 Midland Bank was the world's biggest bank in terms of assets (idem, p. 122) and correspondent agreements continued to grow. By 1939 Midland's business network had grown to over 16,000 respondent banks, 750 foreign branches and over 2,100 bank branches in England and Wales and constituted easily the biggest network in the world.

3.2 Origins and Growth of the Co-operative Bank

3.2.1 Rationale for Bank Choice Selection

The Co-operative Bank was selected as a small specialist bank which increasingly found itself marginalised by the scale and scope advantages enjoyed by competitors. However using outsourcing it was able to access scale and competence strengths of outsource contractors and to respond strongly to opportunities created by market oriented regulatory changes. The strategic reorientation at the Co-operative Bank in response to regulatory opportunities was initially unsuccessful but effective execution of a Total Quality Programme opened several business opportunities that were quite profitable for the bank.

3.2.2 Treasury to the Co-operative Movement (1872-1957)

The Co-operative Wholesale Society (CWS) is the manufacturing and wholesaling subsidiary of the customer owned retail Co-operative movement which opened its first store in Rochdale, England in 1844. The CWS established a Loan and Deposit Department in 1872 to finance the Co-operative Movement's wholesaling activities and expansion. (Datar et al., 1995:1; among others). In 1876 an Act of Parliament established it as the CWS Bank, with all the shares held by the CWS. During its first 75 years the bank's main line of business was acting as official and unofficial treasury to The Co-operative Movement (Euromoney, 1988:26). Alongside the bank's main line of business some retail co-operative societies acted as agents, but personal business,

disadvantaged by exclusion from the clearing process was not emphasised and by 1919 the bank had only 5,000 current accounts.

The bank's main growth opportunities were in its corporate portfolio and due to the success of the co-operative movement's political allies. Trade unions held their assets and provident funds at the bank as did Labour controlled municipal authorities. From the late 1940s through 1957, the bank expanded its branch network to attract deposits from cash rich retail co-operative societies and to expand local authority business (Datar et. al.; 1995:2).

3.3 Domestic and International Growth

3.3.1 Midland's Diversification of International Activities (1960-1980)

After 1945 Midland's international business was handicapped by Britain's weak economic position which required credit restrictions, and exchange controls (overseas branches were reduced to 260). Gradually the pound was replaced by the dollar as the main international trading and reserve currency. Midland's corporate business portfolio for historical reasons was also overweight in declining industrial sectors. In 1963 the then Chairman (Sir Archibald Forbes), General Manager (Howard Thackstone), and Deputy General International Manger (Bernard Clarke) responded by establishing a new international policy designed to meet the needs of large multinationals (Holmes-Green, 1986:249).

[Insert table 3 around here]

Table 3 shows how the policy was implemented in a world wide series of joint ventures and alliances able to finance projects beyond the balance sheet of any single bank. Direct competition between alliance members was minimised although this did not exclude representation in the territory of other members. Meanwhile two of Midland's main competitors (Barclays and Lloyds) also expanded overseas but through a strategy based on take-overs, shareholding and own growth (Holmes-Green, 1986:254).

The massive growth in the largely unregulated Euromarkets in the early 70s wrecked Midland's strategy with foreign banks including many of Midland's erstwhile partners opening in London on their own account. The increasing share of US banks in international markets based on strong relationships with multinational companies and the substitution of securities for bank loans at the top end of the market revealed the danger of Midland's pursuit of correspondent banking while abandoning their own international network (Holmes-Green, 1986:257 and Midland, 1992:23). Midland had little choice but to follow the lead of their UK and US competitors and develop a universal-global bank.

Between 1970 and 1977, Midland's business portfolio expanded to offer a plethora of services and products. These ranged from retail banking in the UK and elsewhere, international and trade finance as well as merchant banking (Midland acquired a stake in Samuel Montague in 1967) and a world-wide travel and traveller cheque business of Thomas Cook (with Midland's stake dating from 1972). Simultaneously, the bank's correspondent banking was extended by 14 new international representative offices and several acquisitions. By 1974 Midland followed Barclays and Lloyds by incorporating the international and overseas portfolio in a new international division (Midland, 1992:22). Ultimately Midland Bank's pursuit of advantage through geographical and product market diversification based on horizontal alliances had failed, eroding the bank's initial size advantages and severely damaging its ability to compete in the following decade.

3.3.2 The Co-operative Bank's Focus on Personal Finance

The competitive gains new competitors were making at the expense of the retail Co-operative movement forced the Co-operative Bank to look outside its not-for-profit and institutional customer base for new growth opportunities. It began a major move towards retail financial products and personal accounts (Richardson, 1977:309) but also commenced merchant banking activities in London round its domestic and Eurocurrency treasury operations. Agency links with co-operative retail societies were wound down with the introduction in-store bank branches between 1969 and 1970. These bank run outlets became "Handybanks" (1977) or "Cash-a-cheque points" (1979).

In 1975, the bank joined the Committee of London Clearing Banks, the first recruit for 39 years, but nevertheless continued to outsource its clearing and transactions procedures to NatWest (Financial Times, 21-X-75). During the early 1970s the bank had quadrupled its customer base and by 1987 provided services to over 800,000 customers (Euromoney, 1988:26). Although the bank was a late entrant into UK retail banking its disadvantages were mitigated by the major performance problems its larger competitors were having following their diversification into the securities business and into international sovereign and corporate lending (see TCB, 1987:3).

3.3.3 Market Specialisation of the Co-operative Bank

However the retail focus did not protect the Co-operative Bank as high inflation and economic recession in the UK increased "failures in 'traditional' markets" (TCB, 1990:6). The resulting provisions for loans to small and medium sized businesses contributed to significant pre-tax losses (respectively £14.7 million and £5.9 million sterling) in 1990 and 1991(Datar, 1995:3). Significant defaults were also occurring on personal and property

lending as unemployment rose to record levels. The Bank urgently needed an upturn in profitability to accommodate the new Basle rules on capital adequacy (TCB, 1990:6).

Mr. Terry Thomas, the bank's CEO used a Total Quality Management (TQM) programme as a lever to control costs and improve service quality (see also Datar et al., 1995). TQM was used to re-focus the bank on core business activities identified as retail banking, the local authority market where the bank had an 18% market leading share and trade union relationships handled directly and through Unity Bank, owned jointly with 30 trade unions. The bank also saw opportunities in asset management and credit card issuing for friendly societies. Overall diversification now meant that the bank's exposure to the Co-operative Movement was below 10% of the loan portfolio (TCB, 1990:8).

3.4 Market Performance and the need for Cost Control

3.4.1 Effects of LDC Debt and Midland's Adventure in California in the 1980s

Midland's 1980 purchase of control in California-based Crocker Bank as part of their revised international diversification strategy precipitated a major loss of competitiveness. Midland underestimated the bad debt exposure of Crocker and problems worsened with a US recession, an associated property collapse and LDC debt problems. Despite further capital injections turnaround eluded Midland who sold Crocker in 1986 losing £750m on their investment on top of a continuing exposure to £6b of LDC debt. A Californian buyer, Wells Fargo, by eliminating duplication of branch and other costs created enough synergy to show a return on their purchase within a year (Midland, 1992:24).

3.4.2 Operating Under-performance and Take-Over by HKSB

Losses on their sovereign and international activities and pressure to meet Basle capital adequacy rules forced Midland to raise make new equity issues. A total of £1.5 billion was issued between 1983 and 1989 including a private issue of £383 million, equivalent to 14.9% of equity to the Hong Kong and Shanghai Banking Corporation (HSBC). Despite this additional capital, the bank's trading position deteriorated making it the weakest UK bank. In 1992, HSBC made a £3.1 billion bid for control prompting a counter-bid from Lloyds Bank. Lloyds pointed to its reputation as the best managed UK bank, evidenced by significant outperformance of its shares relative to the rest of the banking sector and the FT-100 index. However HSBC's existing stake in Midland and a range of collaborations that had developed between them to consolidate their international business (Midland, 1992:25) proved decisive. A take-over by Lloyds would inevitably result in branch closures that would have to be considered by the Mergers and Monopolies Commission while HKSB's bid was unconditional.

Lloyds bid was withdrawn (Beaver-Jennings, 1996 or Stonham, 1993) and HSBC's take-over of Midland transformed the weakest player in the market, into a major competitor.

3.4.3 Results of the Strategy to Reposition the Co-operative Bank

By the end of the 1988-91 recession, the Co-operative Bank had restructured its branch network, opening 107 stand alone branches and reducing banking points in co-operative retail societies from 4,116 in 1984 to 3,000. The 18 month TQM programme resulted in staff reductions of 22% through voluntary severance. Reorganisation costs including severance, a new paper processing architecture and a telephone banking facility came to £6 million. From 1992 onwards, Co-operative Bank strategy emphasised customer retention (i.e. loyalty), with innovative advertising and tight market segmentation designed to win new customers. Specific steps within this strategy are illustrated in table 4.

[Insert table 4 around here]

The new strategy reflected the belief by CEO Terry Thomas that the bank had to re-think its operational philosophy (Datar et al.,1995:3). Based on five market research projects the bank made three observations (The Observer, 9-IV-95). First, only 20% of the bank's personal customers offered high potential for profitability. Second, people in that 20% were younger, better educated (i.e. professionals), more aware and more socially concerned than other members of society. Third, although there was a slight majority of women in the customer base the bank held a market share of less than 2.5% of young educated women.

To attract customers with the desired profile the bank decided in 1992 to feature its ethical stance in advertisements and it also decided to augment the products it could offer existing and new customers. As a result, new products and services built round low cost platforms such as credit cards, telephone and computer and internet banking were designed. The new strategy coincided with economic recovery and pre-tax profits rose by 82% in 1993 to £17.8 million and doubled again by 1995 with after-tax profits of £23.5 million.

4 Two Routes To Innovation in Clearing Payment Systems

4.1 Cost Control and Centralisation at Midland Bank

4.1.1 Containing the Costs of Paper Processing at Midland Bank

Midland's initial attempts to reduce back-office costs echoed those taken by other major UK clearing banks. By the early 1970s, bank branches were "on-line", linking by telephone lines to a central computer (MBSM, 1968). However international losses and capital scarcity resulted in under-investment in Midland's UK retail branch network and in consequence:

"...the majority of Midland's branches [and] staff were still laboriously processing cheques by hand and paperwork was taking up more time and space than customers." (Beaver-Jennings, 1996:189).

This was reflected in Midland's cost to income ratio which at an average of 70.5% from 1989 to 1993 was well above the 65% typical at Midland's closest competitors. (Datamonitor (1994) and Brown-Gardener (1995:3)). Morris-Westbrook (1996:49)) estimated that 72% of Midland's operating costs in 1989 were incurred in back office operations in retail branches with labour intensive paper processing absorbing 60% of Midland's direct staff (Holmes-Green 1986:278) who might otherwise have contributed to product and service improvements.

The worsening competitiveness of Midland's back-office processing and other problems in the 1980s (including LDC-debt and Crocker Bank), imposed severe limits on Midland's income generation. Midland's senior executives became convinced that major economies of scale could be realised by centralising their 300 million items of clearing transactions (Morris-Westbrook, 1996:49). Despite their shortage of resources to execute centralisation Midland did not consider a strategy of second or third party processing (more below).

4.1.2 Midland's District Service Centres - First Attempt (1976-1980)

Midland made two separate attempts to centralise clearing processes (Morris-Westbrook, 1996). The first prompted by a 1971 McKinsey & Co. report (Holmes-Green, 1986:282) although influential was never formally adopted. By 1976 though, Midland were embarked on a "branch network reorganisation" with area offices taking on more processing and smaller branches converted into "service branches" (Midland, 1992:22 and Holmes-Green, 1986:300). These dealt with the day-to-day business and as marketing points for an increased range of domestic and international services (Holmes-Green, 1986:289). Branches moved outside "traditional banking" (idem, p. 278), to offer insurance products, unit trusts, mortgages and in most branches, a range of international products (Eurocheques, foreign exchange and travellers' cheques and travel services through Thomas Cook). However Morris-Westbrook (1996:49) argues the "branch network reorganisation" failed to deliver the expected gains because:

- The removal of data from branch to area office worsened service query handling
- Branch personnel transferred to processing centres lacked skills in mass processing and were unable to deliver expected efficiency levels;
- The centres worked business hours and so processed most work on a next day basis;
- The centres were multipurpose handling money transmission, account openings, standing order and other functions;

- Many centres were located in urban areas, with high operating costs and access problems.

4.1.3 Midland's second Attempt (1989-1991)

Midland's second centralisation attempt was prompted a new CEO, Gene Lochart, an American with an IT and consultancy background. Mr. Lochart appointment reflected an unprecedented move in UK banking to introduce senior executives from outside Midland to replace insiders associated with strategy failures such as the LDC and Crocker Bank write offs . Mr. Lochart's approach to paper transactions sought to correct the problems with Midland's previous approach by centralising in specialist rather than multipurpose centres (Morris-Westbrook, 1996:49-50). The new plan envisioned:

- Attracting business from third parties (like large retailers);
- Using specialists or new employees rather than transferring branch staff;
- The centres taking over all central clearing, "pre-authorised payments", account maintenance and query solution. This aimed to achieve scale economies in paper-processing while improving databases that serviced customer queries;
- Placing the centres outside urban centres.

The programme started in July 1989 and by November 1991 Midland had effectively eliminated branch back offices by centralising processing in 13 purpose-built district service centres (DSC). To implement the project, upgrade to "imaging" technology and adapt US software, Midland relied on the proven expertise and cheque-processing software of its US supplier Unysis. In May 1992, the last branch was converted from back office to DSC processing (Morris-Westbrook, 1996:55).

Midland spent £50 million on the 13 single purpose, large scale and high speed processing district service centres. Once operational, initial targets were met regarding both employee productivity and processing costs (idem.). Midland's cost improvement allowed it to handle non-banking clearing transactions such as postal clearing for targeted customer.

Morris-Westbrook (1996:46) concluded that the second attempt at cost control was more successful because:

- The bank had full and direct support of an IT-proficient CEO to initiate and lead an IT-based innovation;
- Midland's underperformance in a competitive milieu allowed greater scope for change; and

- Managers and IT specialists implemented a project that envisioned a balanced set of requirements. The perspectives of managers and specialists coincided to transform the organisation (including the way work was performed and organised), in ways that revolutionised the basis of competition in retail financial markets.

Cost reductions were achieved because the second reorganisation meant DSCs were exclusively dedicated to process cheques and credits while staff at branches were left with greater time to solve special customer queries and open accounts or standing orders. The centres operated extended hours, were managed by specialists and handled peaks so critical for the system by widespread use of part time and temporary (agency) employees (idem, p.49-50). A saving of 1,564 branch employees was achieved and with "technology at the heart of the low-cost strategy and central to the design of the operation." (Morris-Westbrook, 1996:52) Midland became "...the clear leader in processing costs" amongst UK clearing banks (idem, p.47).

4.2 Capability in processing through outsourcing

4.2.1 Critical Mass through Strategic Alliances

The Co-operative Bank was slow to introduce "on line" systems. Only when Financial Service Centres linked to the central computer in Skelmersdale in 1987 was the bank was able to offer on-line rather than pass-book banking its agencies in co-operative stores. The Co-operative Bank pursued several collaborative solutions (figure 1) to deliver its IT strategy. The bank had only 50 ATMs in its 78 branches but in becoming a founder member of the Building Society LINK Group in 1984 the bank's customers gained access to 400 ATMs growing to 1,000 in 1988 and to 3,500 when the Matrix Group joined LINK (also in 1988). By 1995, LINK gave access to over 8,500 ATMs in the UK alone. The Co-operative Bank contributed only 119 ATMs to this system and these were managed by IBM under a £13 million outsourcing contract signed in 1994.

Recognising their scale disadvantage in keeping up with technical change (Senior Manager, 15-XI-96), the Co-operative Bank entered a £21.5 million sterling outsourcing deal whereby Flexible Information Group (the vendor), took over the bank's systems development and maintenance with 128 staff transferred under a 7 year contract (Datamonitor, 1994:19).

[Insert figure 1 around here]

4.2.2 Development of State-of-the-Art Facilities at the Co-operative Bank

In response to the losses of 1990 and 1991, the bank laid the foundations for what was to become the biggest telephone-banking operation in the UK as part of a re-organisation programme advised by Gemini

Consulting (Datar, 1995:6). The service was launched in 1990 as a means of improving service efficiency and offsetting the bank's competitive disadvantage relative to the 2,500 branch network of its main competitors. Three years later the service was handling 4 million calls a year, and by 1995 “Armchair Banking” was three times larger than that of First Direct (Midland Bank's telephone banking subsidiary, established in 1989). A second service was launched in 1995 to cater for the specific needs of small businesses. Telephone banking provided The Co-operative Bank with a solution to its competitive problems in the SME market arising from a 1% market share and limited branch network.

In 1994, the bank introduced the first fully automated “Bankpoint Kiosk” in Britain to complement its other “minimum” space selling points (i.e. “Handybanks” and “Cash-a-cheque points”). "Minimum" space selling points used technology to perform the functions of traditional branch without requiring the space and investment overheads of conventional branches. In order to provide a 24-hour service area kiosks and mini-branches used ATMs and built-in video-conferencing to link customers and bank staff. Mini-banks and kiosks were also used to project a brand image distinct from the services provided at Co-operative stores.

Terry Thomas, the CEO, thought of kiosks as extensions to existing branches and the established telephone banking system (The Guardian, 7-V-94). The kiosks enabled the bank to provide low cost service delivery reserving expensive manned facilities for selling rather than transaction activities. The success of this innovative outlet strategy depended on enhanced use of available technology but also required improvement in the bank's sub-scale paper processing architecture.

4.2.3 Independent Processing as a Challenge to Major Clearing Banks

In 1982, seven years after joining the Committee of London Clearing Banks the Co-operative Bank established a clearing centre in Prest Street, London, backed-up with computer facilities in Skelmersdale, near Manchester. In order to narrow the bank’s scale disadvantage in clearing the intention was to attract second and third party processing (TCB, 1983:3). As a result a new division (called Direct Financial Services) was created to offer bulk processing and phone-based methods of credit assessment.

A parallel credit card issuing and processing service was also introduced. The decision to centralise and insource rather than outsource followed from a recognition of the strategic opportunities open to an independent non-competitive supplier. In 1983, the bank was: "...poised to become the only completely independent administrator of VISA payment system in the UK outside of Barclaycard." (TCB, 1983:4). Accordingly a

subsidiary, First Co-operative Finance (FCF) was established as credit card administrator to offer VISA processing facilities to other financial institutions (TCB, 1984:3).

4.2.4 Developing Alternative Sources of Income

The early 1980s, saw the beginning of electronic fund transfer in banking but the 1986 Building Societies Act which gave a range of institutions new freedoms to enter the banking market also established new demands for paper processing capabilities. By refusing to offer cheque clearing services for fees the large clearing banks sought to blunt this new competition but the Abbey National Building Society persuaded The Co-operative Bank to undertake clearing on its behalf (Blanden, 1982:89). The Co-operative Bank extended similar arrangements to friendly societies and municipal authorities and subsequently provided processing for the National Giro Bank, some smaller Building Societies and in 1988 the Nationwide Building Society. As a member of LINK and VISA the bank could also attract processing of credit card transactions. Despite this success though the strategy was vulnerable both to a decline in paper processing and to any loss in the Bank's competitiveness in these processes.

The Co-operative Bank, like Midland developed dedicated regional processing centres to improve back-office processing and achieve economies of scale in money transmission (TCB, 1991:5). A major reorganisation in 1991 transferred cheque processing, account maintenance and service tasks from 107 "traditional" branches to 15 Regional Processing Centres (RPC) allowing for staff reductions of 730 (22%) achieved through voluntary redundancy at a cost of £6 million. During the next 18 months costs of £11 million were undertaken for other restructuring and redeployment programs (TCB, 1993:10). Despite further rationalisation at the London, Skelmersdale and Salford DPCs the critical mass needed to cover costs was not being realised (Senior Executive, 15-XI-96), and by 1994 it was evident that the bank could not become a major player in bulk processing. Therefore outsourcing provided the only option for the Co-operative Bank to stabilise the unit cost of paper processing (Financial Times, 19-IX-94).

4.3 Outsourcing Payment Processing

4.3.1 Motivation

In 1993 the Cheque and Credit Clearing Board concerned about rising costs modified its rules regulating the processing and clearing of cheques and credit vouchers to encourage joint ventures and third party providers (Financial Times, 15-XI-93). Allowing outsourcing amongst members and non-members, including non-finance firms was expected to facilitate amalgamation of smaller processing centres.

The London Clearing House also anticipated overcapacity with a 25% fall in the 4.2 billion cheques processed annually by the end of the century to be replaced by electronic-based payments (Humphrey et al., 1996:925). This meant spreading existing largely fixed annual costs of £1.5 billion sterling over fewer transactions. Growth of electronic-based payments also threatened the economic value of "paper factories" built in London's prime site locations (Financial Times, 15-XI- 93), an opportunity.

The downgrading of the competitive importance of paper processing offered Unisys, the Co-operative Bank's IT supplier new opportunities as an outsource supplier. However Unisys lacked reference sales in the European outsource market and the Co-operative Bank's facilities were at the "right size" for full entry into UK paper processing (Senior Manager, 15-X-96). As well as its existing relationship with the Co-operative Bank Unisys had experience in developing high-speed cheque processing systems in the US and was also supplier and consultant for Midland's second attempt at regional processing centres (Morris-Westbrook, 1996:50). As an existing supplier the Co-operative Bank expected fewer problems in contracting non-core paper processing to Unisys than to an alternative supplier (Senior Manager, 4-X-96). Assymetric information between outsource contractor and client. The absence of mutual trust and the thinness of the outsourcing market have been advanced as factors explaining the infrequency of outsourcing (Lacity et al., 1996:22) and may explain why in a UK banking context the Co-operative Bank's ability to reach agreement with Unysis was something of a rarity.

4.3.2 Contractual Details

Although British financial institutions, including the Bank of England, were involved in outsourcing contracts (Richardson, 1993:59) the September 1994 agreement between the Co-operative Bank and Unysis was the first time a British clearing bank had accomplished total outsourcing to a non-bank provider. Rather than Unisys being a vendor the bank thought of them as "strategic partners" (Senior Executive, 15-XI-96) who would handle all of the bank's own, second, and third party processing of cheques and credit card payments, in total representing 8% of the bank paper processing market (Financial Times, 19-IX-94).

The deal was worth £2 million sterling per annum and envisioned the creation of a wholly-owned Unisys subsidiary, to be staffed by 200 people transferred from the Co-operative Bank's own paper processing operations. As part of the deal, the bank could nominate future users (also named "partners") but it was Unisys's responsibility to seek business growth. So far as the Co-operative Bank were concerned "partner" status gave the bank contractual access to current and future cost reductions ahead of potential competitors.

5 COMPETITORS' RESPONSE

5.1 Competitors' Response to Centralisation

5.1.1 British Response

DSCs (District Service Centres) made Midland the lowest clearing cost processor amongst clearing banks and despite criticism from other clearers over excess capacity this enabled Midland to earn extra income from retailers and other corporations with large cheque volume (Morris-Westbrook, 1996:52-56). Despite a clear advantage over the other banks, Midland did not seek to become a processing specialist although they acquired some clearing work from building societies and smaller banks.

By 1991, only one other clearing bank had considered the centralised processing options but by the mid-1990s the competitive environment had somewhat changed. Firstly, banks recognised unrealised value in customer transaction data. Enhanced processing and distribution capabilities were two of the new capabilities required to uncap those opportunities (and in the process turn banks into information brokers, if ethical and legal considerations allowed it).

A second source of environmental change was the 1989-1992 economic recession in the UK. Alongside the growth of electronic and plastic transactions, this led to falling paper-based transactions, problems of over capacity and more aggressive competition in the paper processing market (Senior Executive, 15-XI-96). Cost problems at Barclays Bank, one of Midland's main competitors, stimulated internal debate on whether IT services (including those related to paper clearing) would be better Barclays decided IT intensive processes were strategically essential (i.e. a core capability). IT remained in-house but reconstituted as Barclays Technology Services or BTS a business unit exercising central control over staff and hardware (including clearing). Other business units inside Barclays were not compelled to use BST if outside suppliers offered greater value but as at the end of 1996 none of the business units had exercised that right. Even more positive evidence of the success of Barclays "in-house outsourcing" approach to cost control was provided when in a further refinement IT businesses was put out to formal tender and overwhelmingly retained (Senior Executive, 23-I-97).

5.1.2 Theoretical Implications of Centralisation

Both Midland and Barclays moved paper processing and IT related capabilities from the banks' retail branch to dedicated, purpose-built subsidiaries. The move towards an in-house outsourcing operation

suggested clearing banks solved the challenge of managing investment in new technology (i.e. in specialised physical assets) by placing IT management and paper-processing technology in arrangements named "obligational contracting" (Teece, 1980:231). This approach avoids many of the erstwhile outsourcers' strategic problems because internal providers offer no competitive threats and reduce problems associated with search and selection of independent outsourcing providers.

The ability of two major clearing banks to develop scale and expertise in an IT intensive activity such as paper processing through "obligational contracting" runs somewhat contrary to much of the thinking about outsourcing. Under the "current" approach a potential user of outsourcing will outsource, regardless of capacity if the price offered by the vendor is lower than the incremental cost of providing the function in-house (as originally proposed by Coase, 1937 and Williamson, 1975). But "obligational contracting" or internal outsourcing seeks a mix of cost reductions and improved performance and the continued thinness of the outsourcing markets points to the effectiveness of the internal variant.

The thinness of outsourcing markets suggest that non-contract incentives (such as trust, mutual understanding and fair profit sharing schemes) that allow major clearing banks to achieve optimal outsourcing relations are not commonly present (see further Piore-Sabel, 1984:258-275 or Nelson-Winter, 1982:64). The discussion now turns to the analysis of other banks' IT strategies and the assessment of whether "obligational contracting" was widespread within the diversification strategies of non-major clearing banks. Cases from Britain and elsewhere will consider whether "obligational contracting" as opposed to outsourcing was more likely to provide the sought for mix of cost reduction, service improvement and control of contextual determinants of transaction costs. The cases also consider whether improvements in the cost structures of paper-processing were a necessary element in delivering competitive advantage through product market or customer group diversification strategies.

5.1.3 International Counter Examples

Banco Commercial Portugês (BCP) was one European bank that based its product and customer group diversification strategies on IT capability (Dutta, 1996). BCP was established in 1986 and as a latecomer in a maturing market had to gain market share from entrenched competitors such as the state owned banks which controlled some 95% of total banking assets. In effect, central control had enabled regulators to design a state-of-the-art electronic clearing system superior to that that had evolved in more competitive banking environments elsewhere. However this capital and knowledge intensive system was a major hurdle for new entrants such as

BCP who had neither the scale or experience to process large volumes of transactions competitively. This meant BCP's make/buy strategy was crucial.

In the market evaluation BCP had sought opportunities to minimise its scale disadvantage through outsourcing. The absence of willing/qualified contractors forced BCP to a pre-emptive solution in the form of investment in IT capabilities far beyond their immediate needs. Later on this capability proved crucial in coping with rapid growth and product innovation. Initially BCP sought to cover their costs by a niche approach to relatively price insensitive high net worth individuals but they rapidly developed a diversified business-line portfolio which included most markets within retail banking. By 1991 BCP was a major Portuguese financial institution and a success story in Europe.

As opposed to the experience of Midland Bank or Barclays Bank, BCP used IT capabilities to challenge in bank markets, helped by specific contextual elements such as the government controlled predictability of the clearing processes and the neglected potential of IT to support focused products such as HNW services.

This suggest that IT strategies such as "obligational contracting" represent tactical response to contextual changes rather than visionary solutions. "Obligational contracting" offered Midland and Barclays a device to capture economies not available to non-clearing banks. At the same time, decentralised technical change reduced resource flexibility for UK banks while centralised (standardised) change increased flexibility for BCP. IT over investments offered attractive strategic opportunity in electronic banking while entrenched competitors couldn't develop critical advantage in standard paper based transactions. It seems that contextual changes in regulation policy, economic environment and initial endowments of IT capability are major influences on the build/buy decision in banking IT applications. The outcome of the Co-operative Bank's outsourcing strategy in the following subsection gives further insight into the relative importance of contextual changes and the completeness of the outsourcing markets in determining banks' ability to compete.

5.2 Competitors' Response to Outsourcing

5.2.1 Outsourcing as a route to Critical Mass and Cost Control

The Co-operative Bank's move to control paper processing costs through outsourcing was followed in January 1995 by the Royal Bank of Scotland, (RBS), the six biggest UK bank, to outsource its cheque processing. Cheque processing and clearing as well as direct debits and credit card receipts, were considered by RBS to be

necessary but not fundamental to the business of banking (Richardson, 1993:60). RBS chose its existing cross-border payment system (IBOS) provider EDS to provide the service. RBS transferred facilities valued at £30 million and some 270 staff to EDS (Financial Times, 31-I-95) in an agreement covering the UK branch network. RBS's continental business was excluded on the grounds of insignificance and the complexity of the alliance linkages involved.

5.2.2 Critical Event to Develop Outsourcing Markets

The Co-operative Bank's outsourcing contract was decisive in the development of a market for outsourcing IT in the UK (Loh-Venkatraman, 1992:335). The Co-operative Bank's generally positive experience in managing multiple relationships with suppliers contrasted with the major clearing banks traditional desire to control all their supply chain. The use of outsourcing to offset formidable size handicaps directly encouraged RBS. The Co-operative Bank benefited by acquiring a contemporaneous and homogenous technology platform rather than the patchwork updating of 30-year old legacy systems resulting from in house development.

These considerations suggest that alongside contextual elements, the relative size of the operation distinguishes those banks adopting full outsourcing strategies from those choosing "obligational contracting" (investment in specialised physical assets through exclusively dedicated, purpose-built business units as defined by Teece, 1980:231).

However, size is also important given the thinness of the outsourcing market in UK banking. High concentration levels (Neven, 1990:181) meant that the adoption of either centralised, "obligational contracting" or outsourcing to control the costs of paper-based processing involved non-trivial changes in the competitive equilibrium. A major clearing bank abandoning in-house provision would empower their outsource contractors with the ability to rewrite the economics of that market.

The need to consider market competitiveness (i.e. the degree of concentration) independently of the build/outsource decision justified the use of the BCP example. A further example involving the separation of market competitiveness and the build/outsource decision is provided by Continental Bank. The comparison of Continental Bank's total IT outsource with that of the Co-operative Bank, allows a comparison of two critical experiences in the development of outsourcing markets. The underlying hypothesis is that build/outsource decisions, contrary to Coase (1936) and Williamson (1975), who assume fully developed outsourcing markets are heavily conditioned by the thinness of outsourcing markets.

5.2.3 Non-Cost Incentives to Outsourcing

Besides controlling its own paper-processing costs, the Co-operative Bank used outsourcing to transform budget-based functions into income-driven activities, by changing the performance objective for important (but non-core) activities from budget expenditure (i.e. internal) to fee-income (i.e. market based). This approach followed the example of a number of manufacturing and banking companies (Cross, 1995 or Lacity et al., 1996:21) including Continental Bank.

Huber (1993) and Dutta (1996) describe how Continental Bank faced collapse in 1984. The Federal Deposit Insurance Corp., intervened and a highly successful turnaround followed. Continental had huge sunk (i.e. irrecoverable) costs in IT in developing dozens of stand alone data-bases and applications that did little to provide either speedy and consistent access to relevant data or low costs.

Continental Bank increasingly viewed IT staff as a group of people with their own priorities and time-table and in 1992 became the first US bank to completely outsource IT in order to reduce costs and regain control of the management of information (Huber, 1993:121). Outsourcing allowed performance enhancement (i.e. maximising the returns of budget expenditures), by exposure of otherwise difficult to control functions to a market discipline.

5.3 Analysis Framework for the Build/Outsource Decision

5.3.1 Models of Bank Strategy

Figure 2 summarises the corporate strategy of the four case banks. Both BCP and The Co-operative Bank successfully increased market share while Continental Bank and Midland focused on cost containment. Each of the outsourcing strategies had the potential to achieve sustained competitive advantage in the context in which it was introduced.

[Insert figure 2 around here]

However, it is impossible to disregard the influence of contextual elements on the conclusion. Regional Processing Centres appeared a feasible solution to institutional problems almost simultaneously at Midland Bank and the Co-operative Bank (circa 1987) as did outsourcing at the Co-operative Bank and Continental Bank (circa 1991). In contrast BCP's start up was risky but free of sunk (i.e. irrecoverable) costs in taking the decision to build or outsource IT (1985). From this the interaction of environmental change with the firm's long term strategy, rather than any absolute criterion which determines the core capability or commodity status of particular IT activities.

The case studies suggest that environmental turbulence brought about by technical innovation exposed banks (and particularly major banks) to loss of control of their established profit generating resources (i.e. core capabilities). Environmental change threatened their historic systems and significantly reduced the effectiveness of their established corporate strategy. Smaller banks did not have the choice of defence or attack and had to exploit environmental change and in particular IT-related innovation to offset previous weaknesses.

5.3.2 Effects of Outsourcing Strategies on the Competitiveness of Banking

The relative size of outsourcing markets emerges as a critical element in the outsourcing decision. The case studies suggest that the most innovative strategies in the development of IT outsourcing were rarely initiated at commercial banks despite the synergy unlocked by outsourcing. In pursuing perceived economies of scope some banks discovered that competitive advantage is more clearly defined in terms of capabilities than range of products and markets (Teece, 1980:233). However few banks are willing (or able) to reduce the business portfolio and focus on their core capabilities without the setbacks experienced by Midland, the Co-operative Bank and Continental.

The research shows Midland along with the other big clearing banks faced with the complexity of information systems built over a 30 year period chose to enhance their in house paper processing systems as more economical than outsourcing. Improved cost control and, to a lesser extent, fee-income from second or third party processing justified the decision but the strategic value of investment in clearing processes was undermined by the downward trend paper-based transactions.

Vigorous outsourcing markets also tend to undermine the advantages of major players banks by lowering the capital and scale barriers faced by potential entrants. Improved outsourcing gives small incumbents and new entrants critical scale so destroying the advantage of size and increasing the markets degree of competition.

Relative competitor size might also influence outsourcing strategies. Bigger banks had much more heterogeneous IT capabilities and hence found it difficult to structure appropriate outsourcing contracts. Major banks were willing to promote outsourcing provided they could also control entry and exit to the market but once deregulation brought open entry major banks would have little incentive to remedy any thinness in the outsourcing markets. Outsourcing would then offer low anticipated advantage for new competitors.

6 DISCUSSION

Research presented in this paper found that banks' outsourcing strategies seek a mix of cost reduction and improved performance within the regulatory frameworks and competitive environment they face. The case studies illustrate the influence of historic investments, contextual developments and relative size on banks' strategic response to the rising costs of paper-processing activities. The pursuit of scale through centralisation or cost reduction through outsourcing both provided solutions for specific types of bank. Developing a competitive edge depended on whether banks had potential for major growth and could get access to capital while achieving the critical scale factor (as in the case of The Co-operative Bank, The Royal Bank of Scotland or Continental Bank).

The research also suggested that categorisation of IT activities as core capability as opposed to a necessary condition for competition in bank markets is not independent from the interaction of environmental change with the bank's long term strategy. The growth of outsourcing markets can rapidly destroy what was seen as a core capability and source of competitive advantage of incumbents while increasing the market's degree of competition.

The cases included in this paper focus on firms choosing the outsourcing decision in comparison with competitors facing the same options who choose an alternative solution. Contextual changes are seen to modify incentives for both outsourcing and non outsourcing parties and also for outsourcing vendors and as a result contract renegotiation might alter the logic of the chosen outsource strategy. The challenge for outsourcing strategies is whether banks and their alliance partners can develop and sustain a mutually beneficial, long-term, course of action. In other words only if non-integrated providers can integrate their strategy through the outsource contract to unlock promising additional growth opportunities will outsourcing become more than an intermediate step.

This argument suggests that a future line of inquiry would examine outsourcing contracts from a rather different view point. In particular the degree to which banks develop the ability to organise and manage activities through "markets" rather than through organisational may lead to a wider interpretation of core capabilities.

7 REFERENCES

Alexander, Marcus & Young, David (1996) "Strategic Outsourcing", ***Long Range Planning***, vol. 29, num. 1, pp. 116-119.

Bank of England (1987) "Recent Developments in UK Payment Clearing Systems", ***Bank of England Quarterly Bulletin***, vol. 27, pp. 392-4.

Baumol, William J.; Panzar, John C.; Willig, Robert D. (1982) ***Contestable Markets and the Theory of Industry Structure***. New York: Harcout Brace Jovanovich

Beaver, Graham & Jennings, Peter L. (1996) "Midland Bank PLC", ***Strategic Change***, vol. 5, pp. 185-198.

Blanden, Michael (1982) "All Change in the Retail Market", ***The Banker***, October, pp. 87-90.

Brown, Z.M. & Gardener, E.P.M. (1995) "Bancassurance and European Banking Strategies", ***Institute for European Finance***, RP 95/20, Bangor: University of Wales.

Channon, Derek F. (1988) ***Global Banking Strategy***, Bury St Edmonds: St Edmundsbury Press.

Coase, Ronald H. (1937) "The Nature of the Firm", ***Economica***, November, pp. 386-405.

Cooper, John (1984) ***The Management and Regulation of Banks***, London: Macmillan.

Cross, John (1995) "IT Outsourcing: BP's Competitive Approach.", ***Harvard Business Review***, May-June.

Datamonitor (1994***) Outsourcing in Banks and Building Societies***.

Datar, Srikant; Kaplan, Robert S.; Webster, Robin; & Hampson, Aimée (1995) ***The Co-operative Bank***, Harvard Business School, teaching case 9-195-196, Bedford: The European Clearing House.

Dutta, Soumitra (1996) "Linking IT and Business Strategy: The Role of Responsibility of Senior Management", ***European Management Journal***, vol 14:3, pp. 255-268.

Earl, Michael J. (1996) "The Risk of Outsourcing IT", ***Sloan Management Review***, Spring, pp. 26-32.

Euromoney (1988) "The Co-operative Bank", Special Supplement.

Heffernan, Shelagh (1996) ***Modern Banking in Theory and Practice***, Chichester: John Wiley.

Holmes, A. R. & Green, Edwin (1986) ***Midland: 150 Years of Banking Business***, London: B.T. Batsford Ltd.

Huber, Richard L. (1993) "How Continental Bank Outsourced its 'Crown Jewels'", ***Harvard Business Review***, January-February, pp. 121-129.

Humphrey, David B.; Pulley, Lawrence B. & Vesala, Jukka M. (1996) "Cash, Paper and Electronic Payments: A Cross-Country Analysis", ***Journal of Money Credit and Banking***, vol. 28:4 (November, Part 2), pp. 914-41.

Jennings, David (1996) "Outsourcing Opportunities for Financial Services", ***Long Range Planning***, vol. 29:3, pp. 393-404.

Lacity, Mary C. & Hirschheim, Rudy (1993) "The Information Systems Outsourcing Bandwagon", ***Sloan Management Review***, Fall, pp. 73-86.

Lacity, Mary C.; Willcocks, Leslie P. & Feeny, David F. (1996) "The Value of Selective IT Sourcing", ***Sloan Management Review***, Spring, pp. 13-25.

Loh, Lawrence & Venkatraman, N. (1992) "Diffusion of Information Technology Outsourcing: Influence Sources and the Kodak Effect", ***Information Systems Research***, vol. 3:4, pp. 334-359.

MBSM (1968) "The Branch Terminal", ***Midland Bank Staff Magazine***, January, pp. 434-435.

McFarlan, F. Warren & Nolan, Richard L. (1995) "How to Manage an IT Outsourcing Alliance", ***Sloan Management Review***, Winter, pp. 9-22.

Midland (1992) ***Origins, History and Heritage***, Archives Section, London: Midland Group.

Morris, Timothy & Westbrook, Roy (1996) "Technical Innovation and Competitive Advantage in Retail Financial Services: A Case Study of Change and Industry Response", ***British Journal of Management***, vol. 7, pp. 45-61.

Morris, Timothy (1986) ***Innovations in Banking***, London: Croom Helm.

Nelson, Richard R. & Winter, Sidney G. (1982) ***An Evolutionary Theory of Economic Change***, Cambridge, MA: Harvard University Press.

Neven, Damian (1990) "Structural Adjustment in European Retail Banking", in ***European Banking in the 1990s***, J. Dermine (ed.), Oxford: Blackwell.

O'Heney, Sheila (1996) "Outsourcing is Hotter than Ever", ***ABA Banking Journal***, May, pp. 44-50.

Perry, E.F. (1975) ***The Elements of Banking***, 4th ed., London: The Institute of Bankers.

Piore, Michael J. & Sabel, Charles E. (1984) ***The Second Industrial Divide: Possibilities for Prosperity***, London: Basic Books.

Prahalad, C.K. & Hamel, Gary (1990), "The Core Competence of the Corporation", ***Harvard Business Review***, May-June 1990, pp. 79-91.

Richardson, (Sir) William (1977) ***The CWS in War and Peace 1938-1976***, Manchester: Co-operative Wholesale Society Ltd.

Richardson, Harry (1993) "Pick a Partner", ***The Banker***, April, pp. 59-60.

Stonham, Paul (1993) "The HSBC Holdings/Midland Bank Takeover: Part 1", European ***School of Management***, teaching case-study 293-003-1.

TCB *alias for* The Co-operative Bank.

Teece, David (1980) “Economies of Scope and the Scope of the Enterprise”, ***Journal of Economic Behaviour and Organisation***, vol. 1, pp. 233-247.

The Co-operative Bank (1983 to 1995) ***Annual Report and Accounts***, Manchester: The Co-operative Bank.

Williamson, Oliver E. (1975) ***Markets and Hierarchies: Analysis and Anitrust Implications***, New York: Free Press.

Table 1: Major Issues to Design Contracts for Outsourcing Users

In Favour	*Against*
Parties with equal bargaining power can design efficient sharing rules (i.e. those that lead to joint profit maximisation).	Incentive incompatibility disrupts contracting (users minimise costs while vendors maximise income).
Greater specialisation of users and vendors allows cost reductions through scale economies and firms focusing on core competencies.	Unique location or learning accrue advantages to outsourcing vendors.
Outsourcing users turn otherwise fixed into variable costs.	Finding alternative vendors can be too costly.
Users gain access to critical scale factor, skills or technology. Users can also gain access to superior marketing (i.e. distribution), organisation or customer connections.	Users risk transferring core competencies to vendors or other users. Vendors risk disclosing proprietary technical or managerial procedures or skills.
The user avoids making a stream of investment in future capital.	In the long term, investments in special purpose and/or long-lived equipment may result in users end up paying more to vendors than investing in-house.
The user can maximise budget expenditure when used as substitute of internal discipline procedures (sub-goal pursuit, persistent behaviour or benchmarking groups with special skills).	The user is dependent to the vendor and vulnerable to its instability.
Requires a change in the corporate culture of the outsourcing firm.	Can increase spans of control of managers in outsourcing-user firms.

Source: Williamson (1975), Teece (1980), Hamel et al. (1989).

Table 2: Reasons for Expansion of Outsourcing

Incentives to Outsource	*Characteristics*
Coping with Market Volatility	-Companies abandon diversification to focus on core capabilities. -Reduce cost structures by turning fixed into variable costs.
Lack of Skills	-Improve access to more skilled staff.
Improve Budget Allocation	-Exposure of otherwise difficult to control functions to market discipline.

Source: Lacity-Hirschheim (1993), Lacity et al. (1996), author.

Table 3: Direct and Indirect International Diversification of Midland Bank, 1960-1990

Date	*Country/Area*	*Date*	*Country/Area*
	Joint Ventures		**Direct International Investment**
1963	Western Europe and Commonwealth.	1975	Canada.
1964	North America and Australia.	1978	France.
1972	French Speaking Middle East and North Africa.	1979	Australia.
1973	Iran and other Middle East Countries.	1980	(West) Germany, US, Luxembourg, Switzerland
		1981	Spain, Greece, Italy.
		1982	Sweden.
		1986	Norway, Finland.
		1990	Portugal, Turkey, (East) Germany.

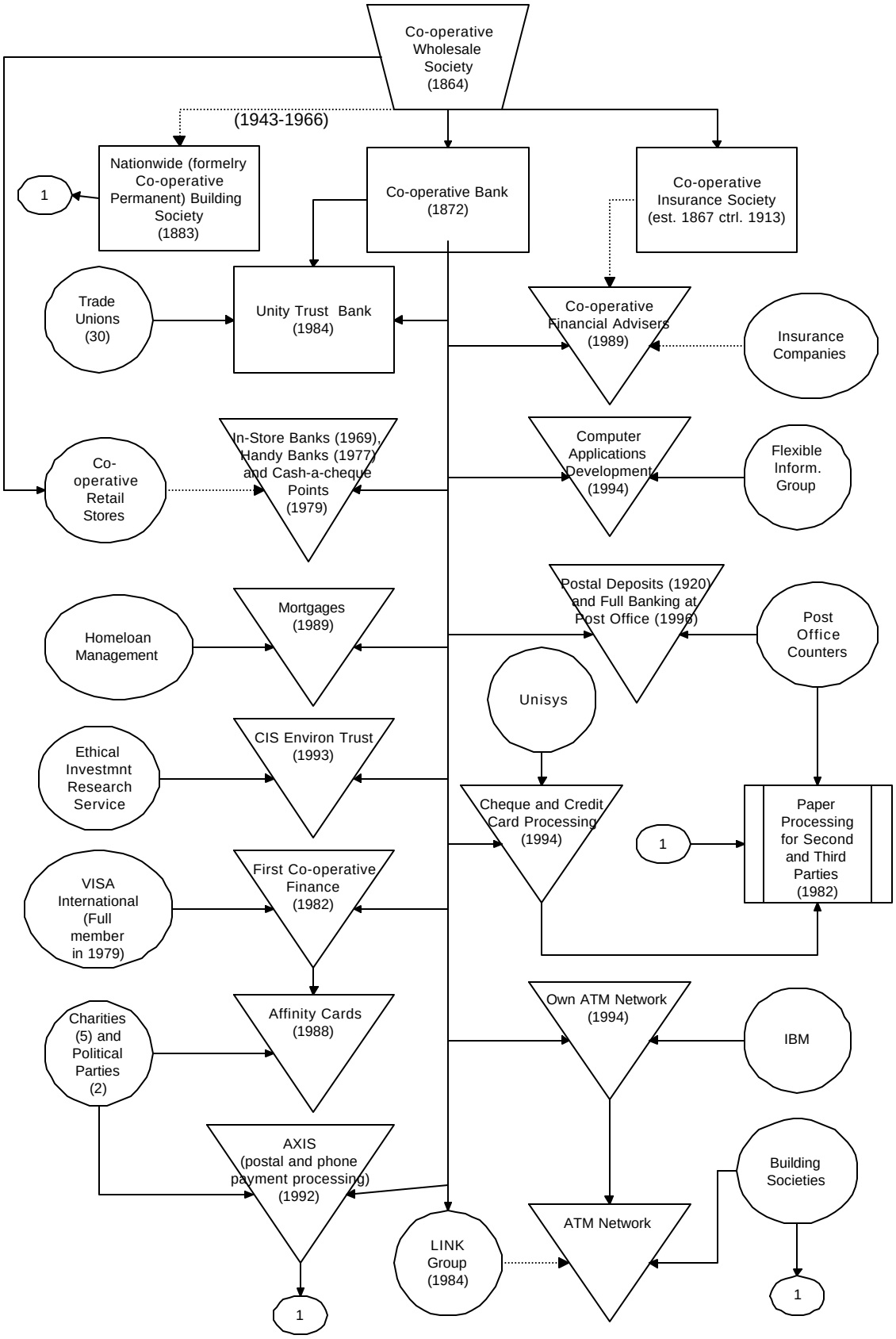
Source: Holmes and Green (1986), Midland (1992).

Table 4: Milestones of The Co-operative Bank in UK Retail Finance, 1970-1995

Date	*Strategy*
1974	Introduction of "free banking while in credit".
1982	First interest bearing cheque account.
1987	First European bank to offer interest on VISA credit card balances.
1989	Entry to bankassurance (agent of Co-operative Insurance Society).
1991	First European bank to offer "free for life" Gold Visa card, that is, no commission for balances above £1,000.
1991	Expansion in bankassurance (agent for several insurance firms).
1992	Ethical Stance (criteria to select firms or organisations with whom the bank would do business).
1993	Launch of CIS Environment Trust (ethical stance extended to create an investment fund).
1994	Quality of Service Guarantee (list of standards to be met when servicing personal account customers and promised to pay £10.00 sterling when not met).
1994	"Customers who Care" programme (affinity cards funding desired charity or political party).

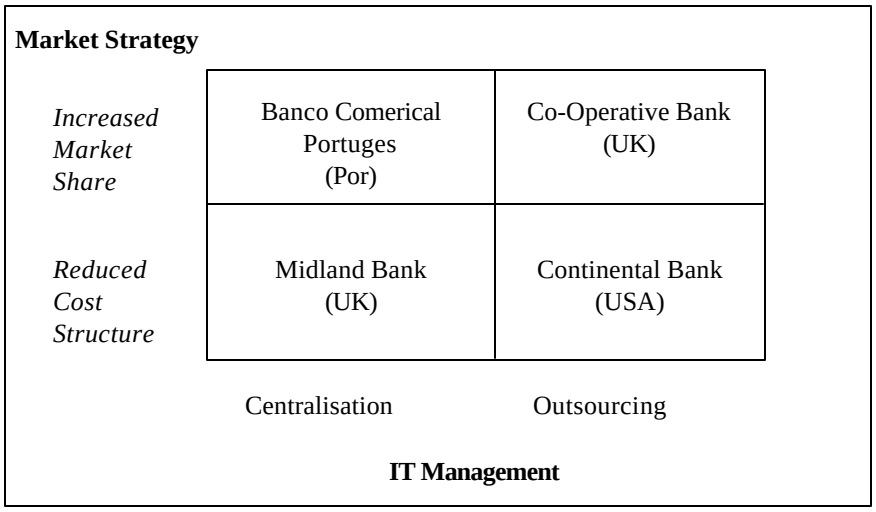
Source: Annual Reports, author.

Figure 1: Stakeholder Map of The Co-operative Bank, 1995
(Selection of outsourcing relationships)



Source: Annual Reports, author.

Figure 2: Analysis Framework for Outsourcing and Centralisation



Source: Author.