
Management of core capabilities in Mexican and European banks

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Abstract

This research considers the way banks have altered their strategies as regulatory change (i.e. deregulation) and information technology (IT) innovations created more opportunities for service delivery and extended the range of potential competitors and forms of competition. These external changes provided new diversification and growth opportunities but also modified prior expectations about the way managers defined and controlled their bank's core capabilities in pursuing current and potential business. The main research instrument used was a one hour, semi-structured interview; and in total 55 managers of commercial banks, investment banks, management consulting firms and regulators from Mexico, Spain and the UK participated. Qualitative and quantitative analysis established that the great majority of banks responded to changes in growth opportunities through diversification moves but with no clear link to core capabilities. IT management played a secondary role in the design of bank strategy but at the same time, IT applications were perceived as an important force to modify competition in bank markets by supporting radical re-engineering of service delivery in ways that undermined previous advantages of scale and scope.

Introduction

This research considers the extent to which changes in the environment forced banks to move from a producer-oriented definition of competitiveness to one that recognised that banks' ability to manage the linkages between activities and customers was the main issue. The possibility that strategic and financial control of capabilities would develop into a competitive edge was originally put forward by Penrose (1959, p. 110) and successfully measured by Rumelt (1974) and more recently by Yip (1982). Surveys of the literature exploring Penrose's propositions for firm growth are found in Ramanujan and Varadarajan (1989), Conner (1991) and Schulze (1994). Penrose's main proposition was that strategic intent which directed the resources, dedicated assets, intangible assets, skills and other inputs to the production process was the main determinant of a firm's ability to compete and capture the most promising growth opportunities.

Strategic intent will also determine whether the firm must develop new capabilities or resources and whether the firm must change co-ordination and co-operation patterns between people, and between people and resources (Grant, 1991, p. 22). Strategic intent, therefore, establishes which resources and capabilities will determine future profitability. These profit generating resources and capabilities that are key to deliver future competitive advantage are called *core capabilities*.

According to Hamel and Prahalad (1994, p. 142), effective control of core capabilities provides the platform by which strategic intent achieves managers' pre-conceived boundaries for the organisation, that is, boundaries in terms of geography, service diversity and customer group. The research that follows established whether, in light of external change and enhanced competition, bank managers had become more confident

in identifying their bank's core capabilities and whether these capabilities supported the diversification strategies generally followed. The research anticipated that bank managers would be able to isolate each stage of their value chain to assess whether activities such as client capture, asset origination or treasury operations were adding value over and above the resources they absorbed. Bank managers were judged to be in control of their profitability drivers only if they could anticipate how external change caused value added to rise or fall in providing bundles of financial services to customer segments.

By collecting bank managers' perceptions on the effect of external innovations on the profitability of individual or bundled services, customer segments, geographical markets and service channels, the research was able to contribute to the description of separate activities that are necessary to underpin an organisation's strategy. The main research methodology consisted of semi-structured interviews. Participants with direct and indirect responsibilities in bank markets from Mexico, Spain, and the UK provided the possibility to explore changes in strategy and how external change altered the strategic gap between banks' actual and desired states.

Managers from Mexico, Spain and the UK were used to represent three distinct competitive environments. Triangulation of responses was then used to identify successful responses to external innovation and, in particular, changes in regulation and information technology (IT) developments. Cross-country and management style differences enabled the research to trace widespread effects of several simultaneous and mutually reinforcing trends that challenged the retail banking services sector in Western Europe and North America during the late 1980s and 1990s. The research, therefore, focused on changes affecting bank markets in general rather than emphasising

changes particular to a country or region (more below).

The survey results also helped to clarify how sustainable advantage creation in bank markets involves matching internal and external adjustment processes. External change was seen as creating dramatic change in both the amount and balance of resources such as labour and organisational skills needed to deliver financial services. Simultaneously technology provided new channels of access to customers offering improved service at one-hundredth of the cost.

The document proceeds as follows. The second section reviews the literature on diversification and changes in competition within bank markets with particular reference to the way banks internalise or externalise the value-added activities used in creating financial services. The third section discusses the methodology used in the semi-structured interviews. The fourth section provides a quantitative and qualitative analysis of interviews. Finally, the fifth section offers a summary and tentative conclusions.

Diversification and resource control in bank markets

The value chain in retail finance

Porter's (1985) original insight into the way management of profitability drivers creates value was further developed by Shepherd (1998) and applied to commercial banks by Canals (1994, p. 199), among others. An understanding of the way value added is created from the separate components of banks' typically complex service offering is vital in underpinning an organisation's diversification or market positioning moves. Value chain analysis also helps to define activities within and around an organisation that create competitive strengths. Canals (1994, p. 198) argues such analysis provides insights into how the implementation of strategic intent will affect cost structures at each value stage.

Value chain analysis was therefore an important tool in analysing the response of managers in commercial banks to external change. Following Klein (1971, p. 206), Benston and Smith (1976, p. 215), Baltensperger (1980, p. 1) and Swank (1996, p. 193), commercial banks are defined as financial intermediaries that accept deposits without explicit payment of interest (sight accounts) and create assets that are generally acceptable means of exchange (paper and electronic payment instruments).

Commercial banks can also be defined from a consumer perspective. According to Lewis (1994, p. 270) and McKechnie (1997, p. 65), there are two service quality expectations that distinguish financial services, namely fiduciary responsibilities and two-way information flows between bank and customer. Firstly, fiduciary responsibilities refer to the responsibility that financial service organisations have regarding the management of their customers' funds and the nature of the financial advice supplied. Secondly, two-way information flows reflect individual customers repeatedly purchasing the same service from the same bank, sometimes over extended periods of time. Financial transactions and particularly those in retail bank markets require a great deal of information that reflects the latest changes in customers' private and confidential financial status.

In brief, customer buying decisions of financial services are likely to be based on experience and credence qualities rather than search or pricing attributes. Information emerging from these transactions can then be used by commercial banks to maintain and develop relationships with existing customers as well as attracting new ones.

Regulation and cross-subsidisation

The centrality of commercial banks to confidence in the financial system and their essential role in supporting economic activity led to a strong regulatory regime emerging in Europe and North America especially following the 1930s (Gilbert, 1984, p. 617). Regulation took for granted that the essential role of retail financial services was to harness savings and channel them into productive investment (Klein, 1971, p. 214) and also that banks operate within predictable environments (Muda, 1993, p. 253). Regulation therefore imposed capital adequacy and prudential requirements to protect depositors from bank default and limited participation in national payments mechanisms to adequately funded and managed banks.

Service issues were not a feature of this regulation. Retail branches were simply distribution points to accept and process client instructions such as deposits, payments and requests for loan facilities. Significant decisions on credit approvals or treasury operations whereby banks deposited funds for investment in organised markets were taken at head or regional offices, rather than close to service points. This reflected the relative importance of

convenient liaison with regulators compared with customer service. Under this framework commercial banks existed as multi-service firms, producing a wide range of services from a largely undifferentiated set of common resources (among others Fraser *et al.*, 1995, p. 7 and Heffernan, 1996, p. 17).

Bank growth revolved around incremental revenue and this favoured the proliferation of financial services and in the absence of clear benchmarks bank charges were subjective, often discriminatory across services and customer groups and involving arbitrary cross-subsidisation (Klein, 1971, p. 216; Neven, 1990, p. 168). In particular unwillingness or inability to charge the economic cost operating current accounts and for use of the national payment systems meant higher charges for other services.

Cross-subsidisation meant activities only weakly reflected their cost determinants or natural geographic areas (among others Gardener and Molyneux, 1990, p. 218; Channon, 1988, p. 14). The aim was to provide enough revenue from a bundle of services to support the apparently irrecoverable costs entailed in being a bank. But in that process managers lost track of the different steps through which a bank's value added rises or falls (Canals, 1994, p. 197). A portfolio of activities contributing at gross margin level but absorbing an indeterminate amount of common resources resulted in blurred pricing schemes that biased the development of banking systems and undermined the assumption that bank managers had control over the drivers of their firms' performance. Not surprisingly until recently the viability of banks was only a minor part of the academic literature on banking (Swank, 1996, p. 194). But with deregulation and with the growing power of technology to track costs and profitability at customer and service level, banks' process culture and undifferentiated strategies were about to face a period of extraordinary challenge.

Support for contestability in banking after deregulation

Among others Gardener and Molyneux (1990, p. 98ff.) and Humphrey and Pulley (1997, p. 83) argue that during the 1980s regulatory and technological change increased the competitiveness of bank markets in Western Europe and North America. According to Baumol *et al.* (1982, p. 269), changes in banks' size and diversity reflected increased competition in bank markets in ways that increasingly met the criteria for perfectly contestable markets. Contestable markets are those where profits are influenced by competition not just from incumbents in a

market but also from external firms which have the capability and right to enter if they choose. If banks are unable to find further cost reductions or income growth associated with economies of scope (i.e. synergy) or from service or geographical economies of scale (i.e. greater size) they can be said to have achieved their optimal size.

Contestability has then achieved the same result as competition in "traditional" competitive markets.

Evidence from the US and UK banking industries failed to provide full support to the proposition of greater contestability of bank markets resulting from deregulation, information technology (IT) innovation and other external changes during the 1970s and 1980s (Bank of England, 1991; Dickens and Phillipatos, 1994). Nevertheless, during the 1970s and 1980s banks experienced reduced rates of financial return despite raised fees for deposit services, reduced branch operating costs and a shift to higher earning assets. They responded to external innovations such as regulatory change and IT applications by marked shifts in their balance-sheet size, business-portfolio diversity and geographic scope (Gardener and Molyneux, 1990, p. 98), though by no means in the same way.

Changes in cost efficiency would thus suggest that regulatory change and IT innovations caused bank managers to reassess the level of resources needed to create value. Indeed, evidence on changes in size and diversity of banks documented in Gilbert (1984, pp. 28, 43), Muda (1993, p. 39), Heffernan (1996, p. 135) and Walter (1997, p. 345) would suggest that changes in banks' size and business portfolio followed external changes over bank markets. But some of this evidence would also suggest that banks' strategic responses were still short of the competitive (or perfectly contestable market) benchmark.

Documented evidence would thus suggest that:

- some of the external changes increased competition in bank markets;
- other external changes modified the provision of factors with which banks undertake their activities (i.e. cost drivers); and
- contestability challenges such as insurance companies entering the unsecured lending market required banks to respond with new service and pricing strategies.

In summary, many studies on the degree of competition in banking aimed to assess external change and, in particular, whether regulatory change and technical innovation

modified barriers to enter and exit bank markets. Variations due to changes in the strategic goals and objectives of bank managers and in their effective control of distinctive resources such as organisational skills, capabilities and other intangible assets were neglected. As a result, evidence remains vague on the role visionary strategies play to explain changes in individual banks' size, scope and diversity as a response to deregulation and technical change.

Research methodology

Questionnaire design

The initial design of the interview built upon drafts of case studies and included six separate interviews with top bank managers. Participants included bank chief executives (CEO), heads of planning and academics who were board members of major clearing banks within their countries. Case studies and open-ended interviews provided a basic agenda on the major areas of concern for commercial banks. Based on these initial encounters work began on the design of a formal interview schedule. The survey initially comprised 44 questions. During the course of further interviews three questions were formally added (more below). In total each interview had a potential of 68 separate answers and the modal response of 41 questions (minimum one and maximum 55). The overall response rate to questions was 55 per cent of the total and thus over-performing initial expectations (Oppenheim, 1992, p. 81). Most interviews took place between April and July 1996, with some as early as March or as late as October. Eight persons (15 per cent of the total) answered a shorter version in writing and these responses were used exclusively for the qualitative assessment.

In total, 20 per cent of the schedule was prompted in check-list form. One out of six interviewees redefined the alternatives prompted, that is, an average 80 per cent of total close-form responses prompted constructs that were plausible indicators of strategic planning in banks and diversification moves in bank markets. Constructs related to banks' strategic planning processes had fewer innovations (12 per cent of total responses) than those into bank diversification moves (16 per cent of total responses).

The semi-structured nature of the interview allowed questions to be reworded where previously unconsidered areas emerged in the course of the discussion (Gordem, 1975, p. 74; Belson and Duncan, 1978, p. 160). The other prompt provided

unanticipated answers for a variety of reasons but especially in relation to time concepts. These time concepts included the years needed to establish long-, medium- and short-term strategies or length of planning horizons. Interviewee assessments also included the need to distinguish between long-term growth and liquidity influences on diversification concerns. As a result, the analysis was able to make a distinction between moves within retail bank markets reflecting a response to liquidity changes within the broad economic cycle; and diversification or repositioning moves made reflecting long-term responses to change in the attractiveness of individual financial service markets.

Question wording and sample characteristics

The interview schedule was initially written in English and aimed to avoid technical terms (following Moser and Kalton, 1978, p. 141). The schedule was translated into Spanish using, as far as possible, equivalents to operational concerns. Each version of the interview schedule was reviewed by independent groups of British, Spanish and Latin American graduate students of Master in Business Administration (MBA), from a highly recognised British institution. The aim of the review was to develop measures that were comparable across countries. In this way the schedule minimised the risk of having translation subtly changing the significance, meaning or overtones of the statements in different social settings (Oppenheim, 1992, p. 184; Foddy, 1993, p. 9).

A problem highlighted by the exercise was the absence of a colloquial equivalent in Spanish for core capabilities. The inherent ambiguity of the widely used concept created problems even in English (as documented in Collis, 1994, p. 143; Hamel and Prahalad, 1994, p. 247; Schulze, 1994, p. 129; among others). Prior to the interview process telephone and e-mail enquiries of four management consultants, four business school academics in Spain and two in Mexico were used to establish current practice. As a result, the interview schedule used *capacidad intrínseca* in Mexico and *capacidades esenciales* in Spain. This was supplemented by a standardised definition in a footnote in the handouts[1].

The survey aimed to capture how similar regulatory changes impacted in three different competitive environments. The benchmark was Britain because it already had large and highly competitive wholesale banking markets, and preceded the other two countries in regulatory changes in its retail

markets (Bank of England, 1991). British participants (33 per cent) in bank markets also seemed to have adopted key technology innovations before the Mexican (24 per cent) or Spanish (43 per cent) banking markets (Gavito *et al.*, 1992). The deregulation timetable in Spain, though starting later, was more intensive as it sought to meet the European Union's Single Market requirements and Euro membership targets (Lloyd-Williams *et al.*, 1994). Mexican banking markets produced comparative data on changes on growth opportunities specific to Mexico and related to regulatory change and on change common to all banks mainly triggered by technology.

Interviewees were split into two categories: participants and observers. Participants were at senior management level in banks with more than two years of direct involvement in the design of strategy at regional, national or international level. Of interviewees, 55 per cent were in this category drawn from commercial banks (43 per cent), *cajas de ahorro* (i.e. Spanish savings banks) (7 per cent) and building societies (5 per cent). Observers had considerable experience in the banking sector but no current line responsibility and included bank analysts from investment banks (24 per cent), management consultants (16 per cent) and regulators (5 per cent). Sector specialists were either in the sample country or at the London office of the investment bank. Management consultants were Partners or Project Managers in all but one case, from a "Top 6" firm. Management consultants also had a minimum of two years' experience in servicing commercial banks. Regulators had experience in the central bank's research or external audit departments. This careful screening ensured all interviews were productive in that they produced credible and internally consistent responses that reflected a sound knowledge of bank strategic management.

In 22 cases (40 per cent) multiple responses came from the same institution although always from different business areas. This duplication proved useful in cross validating judgements about strategic behaviour (Bowman and Ambrosini, 1997) and achieving improved social generality of responses (Foddy, 1993, p. 82). Medium- and small-sized participants based in provincial cities were also included in the sample to increase the diversity of responses and strengthen triangulation throughout the research (Yin, 1984, p. 48; Eisenhardt, 1989, p. 537; Robson, 1993, p. 290). Institutions included in the survey controlled more than

60 per cent of banking assets in each of the countries.

In brief, through triangulation of survey responses the research identified changes affecting retail bank markets. Perceptions of Mexican managers were key to clarify which changes affected bank markets in general to those particular to a country or region. The research then traced how external innovations modified banks' value chain. Changes in how value added rises or falls built upon on managers' emphasis to engage in diversification strategies within retail bank markets based on financial targets, strategic (i.e. market share) targets or a combination of financial and strategic targets. Survey results, therefore, provided insight into the effectiveness of strategic intent to determine future profitability by directing core capabilities to capture competitive advantage.

The effects of external change on banks' value chain

Changes in the competitive environment

The statistical analysis of survey results did not confirm any significant convergence on what might be described as a single model for a bank nor did it provide evidence of a common view amongst bank managers about the dynamics and their control of the profit generating process[2]. This result suggests that despite deregulation and technology change the banking market continues to be segmented. The questionnaire results did establish some important links between contextual elements and banks' corporate strategy. The opportunistic nature of diversification was evident in that 74 per cent of the respondents indicated a tactical rather than a strategic motivation. In these responses diversification moves were more likely to take place during positive states for the economy and/or the market sector.

Table I illustrates that growth potential of individual retail bank markets (i.e. product maturity) was the primary motivation for diversification moves in 36 per cent of cases with the overall growth of the economy as the motive in 16 per cent of cases. In comparison the banks' core capabilities were the primary factor in diversification in 26 per cent of cases and bank specific factors in 23 per cent.

The importance of market opportunities in retail financial services was reflected as expected growth and profitability of individual services relative to core capability considerations. The importance of market opportunities suggested that in bank markets tactical strategies were driven more by

Table I

The economic cycle as an incentive for diversification, 1996

	Mexico (%)	Spain (%)	UK (%)	Sample (%)
Are diversification decisions positively correlated with economic growth?				
Yes	71.4	70.0	80.0	73.8
No	14.3	30.0	20.0	23.8
Other	14.3	0.0	0.0	2.4
Total	100.0	100.0	100.0	100.0
Which is more important for diversification decisions:				
Economic growth	50.0	5.9	20.0	16.1
Product maturity	0.0	52.9	20.0	35.5
Core capabilities	0.0	23.5	40.0	25.8
Other	50.0	17.6	20.0	22.6
Total	100.0	100.0	100.0	100.0

anticipated competitive advantage than by strategic intent. The research further explored the possibility that anticipated competitive advantage was greater when organisational flexibility provided effective response to environmental change (i.e. tactical strategies) than when bank managers focused on enhancing core capabilities (i.e. visionary strategies) prior to diversification.

Table II shows that despite deregulation 64 per cent of responses still see regulation as a constraining factor on domestic diversification with 100 per cent seeing foreign regulation as a constraint on international diversification. This pattern was surprisingly similar for the Spanish and UK banks operating within the Single Market in Financial Services and the Mexican banks operating outside. However 64 per cent of respondents reported that regulatory barriers were less important than core capabilities in determining bank expansion strategies.

It appears, then, that competitive intensity and environmental turbulence also influence the relative importance of core capabilities in determining banks' expansion strategies. More generally, environmental turbulence, such as fluctuations in inflation, economic

growth and business performance, could lead to higher uncertainty about competitive advantage. Mexican interviewees, finding themselves in a turbulent environment, emphasised economic growth and local regulation as limits to their growth while Spanish participants emphasised core capabilities and the growth potential of individual markets (i.e. product maturity). British banks which enjoyed the most stable environment focused on core capabilities, and technical and social developments. Mexican interviewees attached less importance to long-term (visionary) strategies than their Spanish or British counterparts. Competitive advantage for Mexican banks was likelier to arise from tactical strategies or fortuitous association between positioning and environmental change. Their low expectations of achieving sustained competitive advantage arose because of the unwillingness or inability of Mexican managers to sustain the focused budget allocations needed to succeed in the pursuit of corporate vision (i.e. long-term strategy). Overall interview results suggested that banks were far more likely to build their services, channel and customer position as a result of tactical moves than from a

Table II

The importance of regulation as a limit to diversification, 1996

	Mexico (%)	Spain (%)	UK (%)	Sample (%)
Does regulation influence your banks' diversification decisions?				
Yes	84.6	54.5	58.3	63.8
No	15.4	40.9	41.7	34.0
Other	0.0	4.5	0.0	2.1
Total	100.0	100.0	100.0	100.0
What is more important to determine banks' expansion?				
Government regulation	23.1	13.6	0.0	12.0
Core capabilities	53.8	54.5	86.7	64.0
Other	23.1	31.8	13.3	24.0
Total	100.0	100.0	100.0	100.0

deliberate commitment to long-term development of core capabilities.

Banks' internal control: financial considerations and investment decisions

The influence of the competitive environment over the relative importance of core capabilities was further made evident in the valuation of new investments. Results showed that planning periods and investment horizons observed an inverse correlation with the cost of capital (equal to -0.33 on average and significant at the 95 per cent level). Lower environmental turbulence in the UK meant longer break-even periods and planning horizons than in Mexico while Spain was somewhere in the middle. Table III indicates that time spans for strategic investments are far shorter where the cost of capital is high.

Planning horizons differed significantly between respondents. For management consultants, a break-even of one year was expected while bank managers were using multi-year periods. Results also showed that both by country of origin and by sector a longer break-even was accepted for stand alone business than for core or strategic complement business where uncertainty was lower. Since strategic complement or core business are the main source of income, particularly sustained income, the application of faster paybacks to such projects confirmed the tactical approach rather than heavy reliance on strategic or visionary long-term investments. As a result participants seemed to invest in already tested diversification or repositioning moves rather than in creative or visionary projects

requiring a redefinition of operating practice.

The interviews in any event revealed little discrimination between strategic complement or core capability investments and stand alone with the same discount rate applied to all capital investment. Table IV shows that although interviewees considered core capabilities more important than regulation in determining their diversification or market positioning moves the same discount rates are applied to all strategic investments. This confirms the preference for already tested diversification or market positioning moves. The result is also consistent with the growth potential of the individual markets being considered more important than core capabilities in determining banks' diversification moves.

The implication of differential discount rates for stand alone, core and strategic complementary investments is evident when interviewees discussed the relationship between telephone banking and their core capabilities. Some banks considered telephone banking a platform for growth because it increased distribution and client capture opportunities and could be applied to a range of business lines (such as Banco Ixe in Mexico). Indeed, without this competence banks would lose access to an increasing part of their existing market. Other bank managers, however, considered telephone banking a strategic complement to current activities or resources unique to a business unit and, thus, set up new franchises. Examples of the latter include Midland's First Direct in the UK or Banco Santander's Open Bank in Spain.

Table III

Strategic planning horizons and effectiveness of strategy, 1996

	Country of origin			Banks	Sector	
	Mexico	Spain	UK		Analysts	Consult
Expected period for financial break-even (in years):						
Stand alone business	2	3	4	3	4	1
Standard deviation	1.65	1.25	2.70	2.00	2.31	1.00
Business that is critical for core capabilities						
Standard deviation	2	2	4	2	3	2
Standard deviation	1.29	1.59	2.70	1.48	1.70	1.61
Businesses that were strategic complement to existing businesses						
Standard deviation	1	2	3	2	3	1
Standard deviation	1.02	1.13	1.99	1.53	1.46	0.65
Average time scale in strategic planning (in years):						
Long term	2	4	6	4	5	3
Standard deviation	1.38	1.68	2.83	2.25	1.87	1.47
Medium term	1	2	2	2	2	2
Standard deviation	0.70	1.30	1.50	1.41	1.16	0.74
Short term	0	0	1	0	0	0
Standard deviation	0.11	0.48	0.42	0.46	0.53	0.36

Table IV

Discount rates to evaluate new investments, 1996

	Country of origin			Banks	Sector	
	Mexico	Spain	UK		Analysts	Consult
Average cost of equity funds	37.9	12.6	16.0	18.9	17.5	18.9
Standard deviation	10.19	4.13	3.19	12.35	10.39	10.63
Average discount rate applied to evaluate:						
Stand alone business	37.6	12.7	15.2	18.4	15.4	21.1
Standard deviation	11.69	4.46	3.79	12.50	8.90	10.49
Business that is critical for core capabilities						
Standard deviation	36.2	12.1	14.2	17.8	14.8	18.3
Standard deviation	9.96	5.41	3.38	11.81	9.08	10.73
Businesses that were strategic complement to existing businesses						
Standard deviation	36.2	11.9	15.2	17.4	15.4	19.3
Standard deviation	9.96	5.34	3.00	11.67	8.90	10.34

In brief, the implication of relative rankings of discount rates was that some managers perceived core capabilities as platform-based and others saw them as a unique set of profit generating resources. Conceptual problems in defining core capabilities did not seem though to have much impact on the financial expectations placed on new investments. This apparent paradox is further explored in the next section.

Banks' internal control: mixing strategic and financial targets

As far as interviewees could recall, the emphasis in bank markets in their country and at their bank had been to grow the portfolio of business lines rather than increase focus on core capabilities. Discount rates used in project finance were influenced by country-specific factors, such as real rates up to 18 per cent in Mexico or the under-performance of previously profitable non-financial investments in Spain. Nevertheless, in the appraisal of new business plans, interviewees from all three countries reckoned that internal politics, perceived risk profile and expected average synergy were more important factors than expected financial returns to determine new investments. Size was also a factor, since: ... the bigger the investment, the harder it was to place strict success criteria (*Senior Manager*, 25 May 1996).

However, financial returns were considered important when participants assessed the cost of retreat (divest) from a strategic failure. Current financial under-performance according to 46 per cent of responses was the main stimulus to review business continuation. Divestiture was only likely when the business line or business unit had failed to meet financial performance targets over a sustained period of time and when managers' expectations were that future financial returns would be inadequate.

In other words, the influence of expected profitability compared with any formal diversification and divestiture policy explained the importance attached to the overall economic cycle and the growth potential of individual markets rather than strategic exploitation of core capabilities in selecting bank growth opportunities.

When respondents were asked whether financial considerations dominated strategic considerations in strategy design in 18 per cent of cases managers considered strategic criteria as more important, in 46 per cent financial performance to be more important and in 23 per cent considered using both in combination. The main argument used by participants in explaining the emphasis on strategic or financial control involved the level of tolerance to cross-subsidisation. Some interviewees justified cross-subsidisation as inevitable within a "global client" relationship (*Senior Manager*, 29 June 1996), with the need for uniform provision at every point of service enforcing a tolerance of deteriorating market performance in particular market segments or regions.

The possibility of cross-subsidisation suggested that banks set performance targets through strategic control processes and that bank managers perceived core capabilities as a broad platform for growth. Had they perceived core capabilities as a unique set of resources they would have been less likely to engage in activities that effectively inhibit adjustment such as cross-subsidisation. One effect of cross-subsidisation was, therefore, that managers were unable to remove under-performing activities without disrupting the client portfolio.

Managers also tolerate cross-subsidies in the absence of clear economies of scale or economies of scope. Cross-subsidisation allows high financial return business to finance low-return businesses while the latter achieve strategic goals hopefully

stabilising the total profitability of activities through time. Cross-subsidisation may also lower risk since it provides a net result which remains relatively constant in face of short-term environmental change.

Core competencies and diversification in retail banking services

Widespread use of cross-subsidisation means that few bank activities are closely related to their cost determinants or served areas (Gardener and Molyneux, 1990, p. 218; Channon, 1988, p. 14). The participant sample confirmed this view with only 30 per cent being able to provide a distinctive view of their drivers of profitability.

Following Canals (1994, p. 197), bank managers were considered able to identify their core capabilities if they recognised how a bank's value added rises or falls when it provides a changing bundle of services to their customers. Their understanding of effectiveness of distribution, client capture and treasury activities together with drivers such as experience or scale effects, scope or service synergy effects, channel synergy, cost substitution with particular emphasis on IT and human resource management also demonstrate awareness of core capabilities (Canals, 1994, p. 199). Bank managers were considered unable to identify or control their banks' drivers of profitability if they showed low awareness of these drivers and if their banks used extensive cross-subsidisation and pursued portfolio diversification.

Interviewees were further subdivided by reference to diversification strategies. On these criteria the participant sample contained 40 per cent unable to identify core capabilities while actively diversifying (67 per cent in the case of the Mexico). The next biggest group at 30 per cent consisted of managers unable to identify core capabilities but pursuing specialisation strategies. Managers able to identify core capabilities represented in total 30 per cent of the sample and of these 18 per cent were pursuing specialisation strategies and 12 per cent diversification. The details appear in Table V.

The rationale given most frequently by the group unable to identify core capabilities but diversifying was a drive towards potential cross-selling opportunities based on enhanced customer relationships. Incursions into investment banking and bancassurance (i.e. acting as insurance providers) were common in these banks. Inadequate Management Information Systems (MIS) were cited as the main barrier to fully exploiting customer loyalty, cross-selling opportunities or other intangibles and the

development of relational databases to support marketing strategies at customer level was the priority. The need for a core MIS capability to deliver individual customer profitability analysis and support predictive models of customers' purchasing behaviour is implicit even if unrecognised.

Bank-based participants able to identify core capabilities and basing specialisation round them had created indisputable leadership in a number of businesses such as credit cards, mortgages or relationships with small and medium-size enterprises (SMEs). Despite relatively low margins associated with many of the two or three "basic" lines of business, the link to core capabilities clearly determined resource allocation, employee training and development of new skills. New lines of business were considered only if the synergies were strong enough to justify it as a stand alone business.

These specialising banks did support other financial services simultaneously to the "basic" lines of business and these were called non-differentiating services by some interviewees to emphasise that they were not specialist or niche players. Such non-differentiating services are provided only so far as they are needed to satisfy customers recruited for core or basic business lines. The strategic rationale was to avoid the universal bank ethos (i.e. providing all services, to all people and to all geographies). As one interviewee said:

The loss of money accrued while engaging in unknown businesses is far greater than its profitability (even if that return outweighs the opportunity cost of other investments) (*Senior Manager*, 25 June 1996).

This type of incumbent chose building franchise value through specialisation and, accordingly, considered core capabilities as a unique set of resources. Clearly identified core capabilities created enhanced competitiveness in respect of selected markets and customers. Interviewees' preferred path for growth resulted from enhanced internal efficiency and greater penetration within national boundaries.

Diversification and size of commercial banks

The participant respondents able to identify core capabilities yet pursuing diversification strategies considered their biggest growth opportunities to be in cross-border growth and non-related diversification. Non-related diversification included investments in non-financial activities such as telecommunications. Generally this diversifying group was leading banks in their countries judged by asset size, whereas

Table V
 Relationship of core capabilities and business scope, 1996

	Strategy	
	Specialisation	Diversification
Able to identify	0.0 of Mexican 18.2 of Spanish 31.3 of British 18.0 of sample	0.0 of Mexican 18.2 of Spanish 12.5 of British 12.0 of sample
Unable to identify	33.3 of Mexican 31.8 of Spanish 25.0 of British 30.0 of sample	66.7 of Mexican 31.8 of Spanish 31.3 of British 40.0 of sample

Note: As a percentage of total interviewees and participants by country

specialising banks were typically middle sized.

For these diversifying banks the key skills to develop were IT related. Competitive advantage was expected to arise from developing software to support cross-sell opportunities, reduce back-office related costs and manage a plethora of distribution channels. In their internal organisation these banks relied in divisional autonomy as much as co-ordination. They also claimed to be in the process of changing orientation from Strategic Business Units to management by objectives and segmented customer focus.

In summary, more banks anticipate developing competitive advantage through greater diversification than through concentrating on the development of core capabilities. This reflects bank managers' desire to create growth through new business lines instead of favouring slimmer business portfolios or improved use of capital. Natural synergies between disparate businesses are low other than through a unifying database available to staff at any point of customer contact and capable of monitoring profitability in "real-time". Successful IT developments will then enable the banks to tap into previously unexplored customer groups. However, historically technological innovations have tended to move rapidly from a source of competitive advantage to a generic competitive requirement. The logic of widespread focus on an IT-based strategy is consolidation since the scale and experience effects ensure that only a few banks can be winners.

Discussion

The research results suggest generic strategies such as unbridled diversification are perceived to have achieved partial success. As expressed by one interviewee:

So our diversification, in terms of its contribution to the bottom line, is not perhaps

fully understood just yet. Once it is, then we could have a lot of questions being asked as to why are we in this particular market (*Senior Manager*, 20 October 1996).

Different levels of urgency to assess core capabilities suggested that regulation policy had direct but not immediate effects on the development of strategic planning activities at commercial banks. At present only some banks seemed willing to address tough decisions associated with strict budget priorities that logically follow such planning. Hence, an unsuspected effect of regulation policy might have been to favour universal banking as a competitive paradigm because interview results suggest that most banks place greater importance in developing entry deterrence strategies than in mechanisms to identify the most attractive growth opportunities. Bank management seems likely to pursue a mix of financial and strategic goals but striking a balance seems difficult because shared inputs could be equally suited to a number of the strategic opportunities in over-diversified firms.

Interview results also suggested that an overwhelming number of banks realise competitive advantage by tactical and even random strategies rather than making long-term budgetary commitments to develop core capabilities. This finding reinforces a view that deregulation and technological change have increased threats of entry from non-bank and non-finance intermediaries who have the relevant capabilities. The response of bank managers has been primarily to deter the entry of these challengers rather than implementing long-term strategies. For the immediate future most banks will continue to cover potential gaps in their market coverage and deny entry by increasing the number of services provided to their customers and developing IT-based applications for ever finer market segmentation in their home markets. Only a selected number of banks will pursue

geographic diversification. Most are likely to reinforce core capabilities through amalgamations and pursue strategic targets that promise economies of scope.

Succinctly, interview results suggested that bank managers are more likely to pursue strategies on the basis of “traditional ways of doing things” or taken-for-granted assumptions rooted in experience rather than in the basis of resources, processes and skills that are key to provide customer value and sustain competitive advantage.

Finally, the current research offered a review of changes common to retail markets for banking services in three distinct competitive environments (Mexico, Spain and the UK). Future research could then probe deeper to identify key elements in consumer decisions to purchase specific financial services in retail markets characterised by different competitive intensities. One possibility would measure changes in consumer perceptions due to the introduction of the Euro in member and non-member States or deposit insurance schemes in Mexico, the USA and Canada.

Alternatively, research in the strategy to supply retail bank services could focus on how managers in different countries have dealt with environmental forces and fitted their banks’ business portfolio and re-engineered business processes to served markets, customer groups and geographic areas.

Notes

- 1 The definition given was: core capabilities are those dimensions that determine a bank’s competitive position. They are core because without them it would be impossible for the bank to survive.
- 2 Results from two-way ANOVA (with and without replication) together with linear correlation analysis failed to achieve statistical significance. These estimates are available from the authors.

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