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STRATEGIC RESPONSE OF COMMERCIAL BANKS TO REGULATION POLICY AND IT INNOVATION

(Executive Summary)

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Introduction

This article presents interview results which are part of a wider research programme into the control bank managers have of their banks' return generating resources (captured as core capabilities). In particular, changes in growth opportunities within bank markets emerging from deregulation and IT innovations explored through banks' geographic, product market, and customer group diversification strategies within three competitive environments.

Research hypotheses were investigated through a total of 55, 1-hour, semi-structured interviews; with managers of commercial banks, investment banks, management consulting firms and regulators from Mexico, Spain, and the United Kingdom. Qualitative and quantitative analysis of this set of data suggested that domestic competitors rather than foreign banks were perceived as the top driver for change of industrial boundaries. IT management played a secondary role in the design of bank strategy but at the same time, was perceived as an important force of change in bank markets. The great majority of banks reckoned responding to these changes in their growth opportunities through changes in their diversification moves and building upon a platform-based view of core capabilities.

This article is divided in two parts. Part one, presents a framework to analyse the relationship between core capabilities and diversification moves. Part two, relates this framework to semi-structured interviews in three competitive environments.

Part 1: A Framework to Assess Diversification Decisions

1.1 Internal and External Strategies

Commercial banks constitute multi-product firms that can adopt organisational profiles ranging from a narrow or focused to broad range (that is, universal or gobal) structures[i]. Commercial banks adopt specific organisational features driven by strategic considerations based on external and internal growth opportunities. External growth opportunities are opened by regulatory change, technical innovation, developments in the degree of market competition (market structure), and changes in customer preferences. From an internal or production-function perspective, growth opportunities for commercial banks depend on the ease with which operating efficiencies and scale and scope economies can be exploited[ii].

A range of equally viable organisational profiles translates into different cost structures for banks of the same size (and breadth of geographic, product market, and customer group) because managerial skills capture different shares of growth opportunities. "Better" or "superior" bank management skills are thus defined as the ability to create and implement visionary strategies[iii].

Different cost structures emerging from "better" bank management suggest the possibility that competitive advantage can be identified as access to a unique set of resources, skills, and capabilities that effective managers make available to their banks. In particular, whether managers develop new capabilities or enhance the current set of capabilities to tap into opportunities opened by regulatory change and IT innovation. In academic literature these patterns of firm behaviour are called related, semi-related, and un-related diversification as firms respond to new growth opportunities by (respectively) not creating new capabilities, creating capabilities closely related to the no-change-state set, or creating completely new capabilities[iv].

However, if before or after regulatory and technological change banks have access to unique set of resources then greater contestability[v] of bank markets would be an overwhelming response of banks' geographic and customer group diversification rather than product market diversification of new and potential entrants. As long as firms can preserve and develop their stock of unique capabilities then actual or new competition will be irrelevant to implement visionary strategies. In brief, managers' control of return-generating resources provides key insights into how banks implement diversification moves to tap into growth opportunities created by deregulation or IT innovation.

1.2 Management Styles and Growth Opportunities

Since variety in the organisational features of commercial banks supports many alternative styles to bank strategy, it follows that there might be many alternatives to achieve competitive edge by relating diversification moves, tangible or intangible capabilities, and responses to entry threats[vi]. However, grounded work by Michael Goold and Andrew Campbell[vii] is among those studies claiming that the potential response to growth opportunities associates to a reduced number of organisational features. Variety is reduced through management styles establishing, first, whether top executives regard as important the contribution of middle managers to detect growth opportunities and second, whether top executives consider that competitive advantage will emerge from integrating activities round financial or strategic objectives.

Table 1 illustrates these strategic styles, their likely distribution, and their relation with a particular form of control and performance objectives[viii]. The first of these styles is called “financial control” to encompass senior managers who believe better management emerges from them setting tight expenditure objectives or strict performance targets and thus, leaving most planning decisions to business unit managers. The second style is called "strategic planning" to identify whether an authoritative CEO or a group of top managers integrate business activities round strategic targets (such as market share) and thus, cross-subsidies activities (that is, high-financial return businesses finance low-return businesses while the latter achieve their strategic goals). The third style is called “strategic control” and aims to represent senior managers who believe in active influence and participation of business-unit managers to discover growth opportunities while aiming to strike a balance between market performance and resource allocation within the organisation.

Table 1: Types of Strategic Management Styles and their Distribution, 1996

	Type of Enforcement	
	Tight (Strict) Control	*Flexible (Collegiated) Control*
Objective		
Financial	Financial Control Average 16.7% (Mexico 21.4%) (Spain 13.0%) (UK 16.7%)	Strategic Control Average 33.3% (Mexico 35.7%) (Spain 39.1%) (UK 22.2%)
Financial and Strategic	Strategic Planning (Prominent Person Approach) Average 23.5% (Mexico 0.0%) (Spain 26.1%) (UK 44.4%)	Strategic Planning (Collegiated Approach) Average 27.1% (Mexico 42.9%) (Spain 21.7%) (UK 16.7%)

Source: Goold and Campbell (1987), Goold et al. (1994), author.
Sample: 55 managers in three countries, April to June 1996.

There are two elements in the criterion used by these management styles to assess diversification moves. First, diversification must be expected to create value, either from the new business to the parent company or vice versa. Secondly, through diversification the parent organisation must be expected to add more value to the new business than any other potential parent[ix]. These two necessary conditions for competition suggest that strategic styles reflect (rather than cause) competitive advantage and point towards patterns of behaviour useful to identify treats of how strategy is formulated. Such features are reflected in tendencies particular to each style[x]:

- "Strategic planning" companies favour organic growth (that is, increase core capabilities);
- "Financial control" firms would tend to favour diversification through acquisitions; while
- "Strategic control" companies would also favour growth through core capabilities but balancing this growth with consolidation or divestiture of non-performing businesses and as result, maintain without change the overall dimension of the firm.

1.3 Relationship between Strategy, Diversification and Core Capabilities

Growth features associated with management styles have an implication on the type of diversification move each style is likely to adopt as a response to external change. Firstly, growth features of management styles suggest managers in "financial control" firms will impose lower time-spans for diversification moves to achieve profitability or higher rates of return to evaluate the present value of these diversification moves. This profile for strategic investment criteria emerges from "financial control" firms perceiving each diversification move as a "stand alone" business.

The specific response to deregulation and IT innovation of banks engaged under "financial planning" style is likely to develop upon managers' perception of core capabilities and whether they aim to pursue scale or scope economies. Geographic concentration together with product-market and customer group diversification, seems more likely for "financial planning" banks when capabilities are perceived as a broad platform for growth. Patterns of scope diversification emerge as return-generating resources associate with managers' ability to transfer proprietary information (intangible capabilities such as "Knowhow") to alternative activities at lower costs than those incurred by independent business units[xi]. On the other hand, the degree of competition does not seem to be a barrier to pursue growth through scale, that is, "financial control" managers seem likely to complement geographic diversification with business line consolidation to capture benefits associated with specific or unique capabilities. See further table 2.

Table 2: Likelihood of Diversification Move and Management Style

Management Style	*Core capabilities perceived as:* *Platform-based (Economies of Scope)*	*Unique (Economies of Scale)*
Financial Control	-Geographic concentration. -Product-market diversification. -Customer group diversification.	-Geographic diversification. -Consolidation of business lines. -Customer group diversification.
Strategic Planning	-Geographic diversification. -Product-market diversification. -Customer group diversification.	-Product market diversification. -Narrow geographic span. -Customer group business.
Strategic Control	-Narrow geographic span -Focus on product markets. -Customer group diversification.	-Narrow geographic span -Focus on product markets. -Customer group specialisation.

Source: Author.

Banks managed under "strategic planning" styles seem likely to be less concern with potential entrants (than those at "strategic control" banks) because of their slower reaction to poor performing business[xii]. That is, relatively bigger time spans assigned to strategic investments and thus, for diversification moves to achieve profitability. A predisposition to universal and even global banking seems likelier for "strategic planning" banks perceiving core capabilities as a broad platform for growth as they aim to maximise cross-selling opportunities to the established customer base. On the other hand, for banks building upon unique capabilities achieving scale through product market diversification seems more attractive.

Banks managed under "strategic control" styles seem likelier to assign lower time spans for projects based on core or strategically important capabilities than to "stand alone" capabilities. The pursuit of scale economies (based on a perception of capabilities as a broad platform for growth) seems likely to be followed by customer group diversification. As mentioned, scale economies associated with benefits of unique resources and therefore, "strategic control" perceiving their capabilities as unique are likely to focus on specific customer segments. Since "strategic control" managers do not seem concerned with firm-size growth, the likeliest response to deregulation and IT innovation seems to be pursuing scale or scope based on a narrow geographic span and focus on product markets.

1.4 Relative Importance of Core Capabilities for Bank Growth

A trend emerging from interview results referred to whether financial considerations were or were not dominant in strategy design. In 18% of cases managers cited strategic criteria as the most important, 46% of results indicated financial performance to be more important, and in 23% of the cases a combination of market (strategic) and financial performance.

There were two main arguments used by participants to explain the emphasis on strategic or financial control. Again, these arguments evolved round a perception of unique-based or platform-based capabilities, that is, round a tolerance of an element of cross-subsidisation which effectively inhibits adjustments. Some banks carry under-performing services with the aim of securing or maintaining "global" relationships with clients with the effect that under-performing activities could not be removed without effectively removing the client portfolio. Managers, too, were prone to "market commitment" (Senior Manager, 29-VI-96); that is, tolerance of deteriorating market conditions to serve designated market segments or regions. The provision of universal banking services often involved cross-subsidies in the absence of clear economies of scale or scope. These goals aimed to secure profitability in "global" relationships (that is, as a result of total services consumed by the client). Obviously, absence of reliable costing of the service consumed could severely bias "global" profitability estimates.

Table 3 illustrates results that stem from interviewees' perception of the influence of economic growth has over banks’ diversification strategies. In 63.0% of the responses participants agreed that regulation limited their diversification strategies. However, in 64.0% of the cases core capabilities were more important than regulation to determine bank expansion. Even more, the relative importance of core capabilities differed across countries with Mexican interviewees emphasising economic growth and local regulation. Spanish participants emphasised core capabilities and product maturity; while British managers focused on core capabilities, and technical- and social developments. These results suggestes that Mexican interviewees were less likely to adopt long-term (visionary) strategies than their Spanish or British counterparts. In fact, competitive advantage for Mexican banks seems likelier to arise from tactical strategies or random change (that is, fortuitous association between positioning and environmental change). This as few Mexican banks seemed willing (or able) to address tough decisions associated with the focused budget allocation needed to succeed in the pursuit of their corporate vision (that is, long-term strategy).

Table 3: Relationship between Threat of Entry and Regulation, 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%
Sum	*100%*	*100%*	*100%*	*100%*
What is more important to determine banks' expansion?				
Government regulation	23.1%	13.6%	0.0%	12.0%
Core competencies	53.8%	54.5%	86.7%	64.0%
Other	23.1%	31.8%	13.3%	24.0%
Sum	*100%*	*100%*	*100%*	*100%*

Source: Author.

In summary, this first part considers issues related to how greater contestability of bank markets modifies perceptions on the relative importance of diversification moves based on managers control of core capabilities within a framework developed by Michael Goold and Andrew Campbell. The second part of the article proceeds comparing a valuation of strategic investment decisions by alternative styles at bank management. The distribution of results has clear implications towards the relative importance of core capabilities to growth opportunities through diversification moves of universal, global, and specialised banks. The discussion also uses the distribution of results on strategic investments as building block to ascertain competitive threats in bank markets (that emerge from established and potential participants that respond to regulatory change and IT innovation).

(*Note*: References and footnotes appear at the end of part II).

Part II: Managers' Perception of Change

1.1 Characteristics of the Sample

As mentioned before, this research evolved round banks' approach to defining boundaries to their activities with respect of geographic scope (global banking), business lines (universal banking), and customer group. Because the research considered three operating environments (that is, markets with unequal degrees of competition) differences in regulatory and technological stages could be linked to diversification decisions. Moreover, using countries in distinct markets provided an opportunity to see common or shared responses and so disentangle phenomena affecting banking markets generally from those affecting just one geography. In brief, the research explored the strategic intent and actual outcome of planning processes under three regulatory systems. Table 4 illustrates the distribution of interviewees.

Table 4: Geographic and Sector Distribution of Participants in Survey, 1996

Participants: Observers	Participants: Incumbents (Country →)	Mexico	Spain	U.K.	Sum
	Banks	6	9	8	23
	Cajas de Ahorro	0	4	0	4
	Building Societies	0	0	3	3
Bank Analyst		4	6	3	13
Consultants		3	3	3	9
Regulators		1	1	1	3
		14	23	18	55

The questionnaire built upon drafts of case studies and included six separate. open ended, interviews (with bank CEOs, heads of planning, and academics). Interview topics encompassed diversification decisions (that is, disposing or acquiring business lines); elements to establish where and how the bank would compete; evaluation of market performance; and the main future determinants of competition (identified as drivers of strategic change). Diversification was broadly defined and aimed to reflect long-term responses to change in the attractiveness of product markets, geographic setting, or specific market segments (customer group).

The interview schedule was written in English and aimed to avoid technical terms and intentionally invited participants to relate their conceptual explanations to descriptions of tangible events from their own experiences. The survey schedule was translated into Spanish using, as far as possible, equivalents to operational concerns. To develop measures that were comparable across countries independent groups of British, Spanish, and Latin American MBAs reviewed each version of the interview schedule. 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.

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[xiii]. Prior to the interview process telephone and email enquiries of management consultants (4), business school academics in Spain (4) and Mexico (2) were used to establish current practice. As a result, the interview schedule used a different term for each geography (“capacidad intrínseca” in Mexico and “capacidades escenciales” in Spain). Moreover, a standardised definition supported each of these terms in the form of a handout[xiv].

1.2 Initial Results

It was anticipated that either country of origin (i.e. competitive factors), type of diversification move (i.e. growth opportunity pursued), strategic style (i.e. management approach) or type of respondent (that is, distribution by sector) would result in a statistically significant grouping of results. However, all estimates of the two-way ANOVA (with replication) failed to reject the null hypothesis of equal means, that is, the combination of great construct variety and sample size resulted in no-one single dimension accruing for most of the variance in the results (not shown for brevity). This was not the case for correlation emerging from the "country of origin" partition as its values associated with the highest linear correlation coefficients (not shown for brevity).

A striking difference in strategic horizons was observed between countries and amongst those reported by management consultants and banks. Results suggested that the specific nature of projects assigned to management consultants limited their ability to perceive strategic trends of individual institutions. This is further illustrated in table 5 (information is available from the authors on averaged discount rates used to evaluate strategic investment projects).

Table 5: Strategic Planning Horizons, 1996

	Country of Origin			*Type of Participant*		
				Incumbents	*Observers*	
	Mexico	*Spain*	*UK*	*Banks*	*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	2	2	4	2	3	2
	1.29	*1.59*	*2.70*	*1.48*	*1.70*	*1.61*
Business that had strategic complementarity to existing businesses	1	2	3	2	3	1
	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
	0.70	*1.30*	*1.50*	*1.41*	*1.16*	*0.74*
Short Term	0	0	1	0	0	0
	0.11	*0.48*	*0.42*	*0.46*	*0.53*	*0.36*

For both "country of origin" and "type of participant" groupings, there was a longer break-even for "stand alone" business than for "core" or "critical" business suggesting, in turn, a faster payback for activities (presumably) associated with less uncertainty as the latter are part of on-going endeavours. This result, however, raised an interesting question. Since "critical" or "core" business are the main source of income, faster paybacks suggested that rather than strategic, visionary, or long-term investments; participants were providing information that scored tactical moves. In order words, most participants seem to invest in already tested diversification moves rather than to explore alternative venues (that is, creative or visionary projects that aim to redefine industry boundaries).

Results suggested that either "core capabilities" was not a widely used concept, the majority of banks implicitly pursued a platform approach to growth, or there was a gap in the relationship between growth and core capabilities. These alternatives emerged as unexpectedly, interview results consistently scored "critical" or "core" capabilities with the same value as "stand alone" businesses (in terms of discount rates for capital budgeting). Moreover, as some banks considered telephone banking a core capability because it increased distribution and client capture opportunities and could be applied to a range of business lines. Indeed, without this competence they would lose access to an increasing part of their existing market. Others, however, consider it strategic complement to current activities and set up new franchises (like Midland's First Direct in the UK or Banco Santander's Open Bank in Spain). As a result, the analysis proceeded assuming there was room for some manager to perceive capabilities as platform-based or unique-based.

1.3 Investments in Return-Generating Resources

During the course of the interviews, investments in "core capability" aimed to identify projects that were:

> "...best managed on a co-ordinated, integrated basis, despite the additional corporate costs this entails."[xv]

Investment in core capabilities presumably identified a broad (platform) perspective of capabilities as this type of investments increase in the markets served because core capabilities are essential to the majority of products and the client base. However, strategic complementarity as a concept also encompasses co-ordination, sharing skills, or optimising infrastructure; in a way that precludes independent management and distinctive lines of responsibility. Strategic complementarity aimed to capture managers perceiving capabilities as unique or specific.

The fact that few participants were able to provide a distinctive view of their drivers of profitability led to the segmentation of incumbents into four groups. In 40.0% of the results suggested managers that followed a platform-based view of capabilities as they were unable to identify core capabilities while pursuing diversification moves. This was the biggest group of managers and where Mexican interviews scored the highest percentage with 66.7% of that sub-sample. Results suggested the next biggest group were managers unable to identify core capabilities while pursuing specialisation strategies (with 30.0% of the results). Managers able to identify core capabilities and specialising were identified in 18.0% of the interviews and those able to identify and diversify encompassed 12% of the interviewees. Table 6 summarises these dimensions.

Table 6: Relationship of Core Capabilities and Business Scope

(As a percent of total interviewees and participants by country)

	Strategy	
	Specialisation	*Diversification*
Able to Identify	18.00% of sample (0.0% of Mexican) (18.2% of Spanish) (31.3% of British)	12.00% of sample (0.0% of Mexican) (18.2% of Spanish) (12.5% of British)
Unable to Identify	30.00% of sample (33.3% of Mexican) (31.8% of Spanish) (25.0% of British)	40.00% of sample (66.7% of Mexican) (31.8% of Spanish) (31.3% of British)

Source: Author.

The most common account amongst those managers able to identify core capabilities (while pursuing diversification strategies) was their need to develop key skills in IT related areas. In particular whether they could leverage the established capability-base to tackle threats and opportunities of electronic commerce. Two alternative strategies were described. Firstly, engaging in collaboration agreements with IT and non-finance partners. Secondly, reorganise the current internal structure to develop specialised bank, non-bank, and non-finance subsidiaries that centre on a limited set of capabilities, and operate within an umbrella organisation.

Results emerging from the overall sample showed that managers ranked IT third in importance (after greater income growth and risk control) to determine their diversification moves. Specifically, improving the performance of distribution channels had the same level of importance than enhancing core capabilities as a future concern for market positioning. Moreover, surveys of international financial institution (carried out in 1993 and 1996), determined that as a force of change in financial markets technological advances consistently ranked fourth in its importance to define the boundaries of bank markets.

In brief, IT innovations and particularly, cross-border payment systems such as those developed for electronic commerce could stimulate some banks to focus on their core capabilities[xvi]. However, this result is contingent to bank managers' firm control of the return generating resources (that is, their perception of unique or broad-based core capabilities) and their perception of diversification strategies from non-bank and non-finance intermediaries. These are competitive conditions that, succinctly, are seldom explored in the literature on bank performance[xvii].

[i] Among others, Walter, Ingo (1997) "Universal Banking: A Shareholder Value Perspective", European Management Journal, vol. 15:4, p. 345.
[ii] idem.
[iii] ibid, pp. 345 and 350.
[iv] Penrose, Edith (1959) The Theory of the Growth of the Firm, (Second edition, 1980), Oxford: Basil Blackwell. p. 110. See also Rumelt, Richard P. (1974) Strategy, Structure and Economic Performance, Boston, MA: Harvard Business School Press or Chatterjee, Sayan & Wernerfelt, Birger (1991) "The Link between Resources and Type of Diversification", Strategic Management Journal, vol. 12, pp. 33-48.
[v] The contestability of bank markets refers to investments that secure entry, provide entry deterrence, or create threats of entry into new markets. Alternatively, as the barriers and costs to enter new markets faced by new and potential competitiors. See further Baumol, William J.; Panzar, John C.; Willig, Robert D. (1982) Contestable Markets and the Theory of Industry Structure. New:York: Harcout Brace Jovanovich.
[vi] See further Ramanujan, Vasudevan & Varadarajan, Rajan (1989) "Research on Corporate Diversification: A Synthesis", Strategic Management Journal, vol. 10(6), pp. 531-51.
[vii] Goold, Michael & Campbell, Andrew (1987a) Strategies and Styles: The Role of the Centre in Managing Diversified Corporations, Oxford: Basil Blackwell. Also, Goold, Michael; Campbell, Andrew & Alexander, Marcus (1994) Corporate-Level Strategy: Creating Value in the Multibusiness Company, New York: John Wiley & Sons.
[viii] idem, p. 46 and 420, respectively.
[ix] idem.
[x] ibid, p. 161.
[xi] Teece, David J. (1980) “Economies of Scope and the Scope of the Enterprise”, Journal of Economic Behavior and Organization, vol. 1, p. 226.
[xii] Goold and Campbell (1987, p. 160).
[xiii] See further Collis, David (1994) "Research Note: How Valuable are Your Organizational Capabilities?", Strategic Management Journal, vol. 15, pp. 143; Hamel, Gary & Prahalad, C.K. (1994) Competing for the Future, Boston MA: Harvard University Press, p. 247; Schulze, William S. (1994) "The Two Schools of Thought in Resource-Based Theory: Definitions and Implications for Research", Advances in Strategic Management, vol. 10A, pp. 129.
[xiv] The quote read: 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."
[xv] Reinton, Sigurd W. & Foote, Nathaniel (1988) "Adding Corporate Value: Why Parents must be more Particular", McKinsey Quarterly, Winter, p. 51.
[xvi] See further Langlois, Richard N. & Robertson, Paul L. (1995) Firms, Markets, and Economic Change, London: Routledge, p.120; or Canals, Jordi (1997) Universal Banking, Oxford: Claredon Press, p. 276.
[xvii] See further Muda, Muhamad (1993) “Environment, Organization and Bank Performance”, Ph.D. Thesis, University of Manchester, Faculty of Business Administration, p. 22; Kaplan, Hasan H. (1994) "Openness to Change and Budgetary Control in Turkish Banks", Ph.D. Thesis, University of Manchester, Faculty of Business Administration, p. 56; Newkirk-Moore, Susan (1995) "Strategic Planning: Steering the Small Community Bank to Profitability", Journal of Strategic Change, vol. 4, p. 335; or Bátiz-Lazo, Bernardo (1998) “Internal and External Influences on Innovations in Commercial Banking”, Ph.D. Thesis, University of Manchester, Faculty of Business Administration, p. 16.