

Cluster 4 in 2005

“Reshaping the Banking Organization”

1 PROJECT SUMMARY

Over the last ten years the banking industry has gone through some sweeping changes. Disintermediation, consolidation, outsourcing and securitization are just some of the most prominent buzzwords that commentators have been using to describe major trends afflicting an industry that itself was deemed the steel mills of the nineties even by many industry insiders. We reckon that major changes will also take place over the next decade and therefore pose the following overarching research question: “How will the banking industry look like in the years from now?” Given the broad nature of the research topic, we have rephrased the question to guide our activities over the next three years: “What are the evolving, optimal boundaries of the banking firms?”

A reference to Adam Smith – the founder of modern economics - makes clear that this is indeed an important and also complex question. His famous example on the evolution of the needle production showed that degree of specialization is a main determinant of overall welfare and industry competitiveness. Shall and will today’s banks specialize around customer segments, product areas, or value chain elements to maximize value creation or will we still be observing highly integrated universal banks in the future?

We have subdivided our research activities into three work streams. **Work stream 1** (“The banking value chain”) focuses on those activities that most banks do not consider to constitute core competencies, namely administrative and IT functions. We investigate optimal sourcing strategies for these functions that enhance overall efficiency and allow banks to free up resources for their core activities. **Work stream 2** (“Credit process excellence”) aims to generate a detailed perspective on one of these core activities, namely the lending business. We will analyze the implications of Basel II, securitization technologies, process automation etc. on the lending business models. **Work stream 3** (“Customer behavior and financial services distribution”) deals with the revenue-growth agenda of banks. Proceeding from a better understanding of customer needs and customer behavior we will investigate how banks should design and price their market offerings and organize their distribution function.

Methodologically, we aim to derive positive as well as normative assessments on the likely developments in the banking business by building upon prior own research and by means of reviewing the literature, expert interviews, theoretical model design and empirical analysis. Ultimately, managers as well as scientists shall be provided a better understanding of how exactly and to what extent value will be created in reshaped banking organizations of the future.

1.1 Motivation

Back in the early 1990s “breaking up the bank” used to be a popular slogan among many commentators on major trends in banking. Although the technological means to unbundle highly vertically integrated banking firms were already available at this time, it took yet another decade until German banks started to actively search for new ways to restructure and reorganize their lending function. Extraordinary positive effects like the re-unification and booming equity markets had obscured what many have been viewing as a structural crisis that is due to inefficient processes and excessive branch networks. Not only have these positive effects vanished - other negative effects such as the Y2K- and the Euro-conversion, write-offs and follow-on costs of enormous internet technology investments as well as the general economic downturn have dramatically increased the pressure on banks to cut costs. Hence, we now observe a situation in which sophisticated IT solutions and the emergence of large sophisticated service providers coincide with the accepted need to radically rethink the way banks operate their business in a more cost-efficient manner. As evidenced by recent transactions by major players, banks indeed start to concentrate on their core competencies and to outsource non-core activities.

Moreover, securitization technologies and emerging credit business factories will most likely have an impact on most banks’ future lending business value chain in particular. Some banks are already changing their business model from a credit risk taker to a credit risk broker. Because German firms

are still heavily reliant on bank loan finance, we consider an in-depth analysis of how banks will perform their loan intermediation function in the future as essential.

The adverse capital market environment of recent years has not only revealed the structural efficiency problems that many German banks have been facing but has also lead many banks to seek for income streams that are more stable than those from capital market oriented, fee-based activities. This in turn has been reinvigorating large banks' focus on their retail banking operations. Many banks are reconfiguring their service offerings to better meet the needs of selected customer segments. At the same time banks are enhancing the skills of their client-facing staff and are redesigning incentive systems to proactively sell these services to existing and new customers. Given that the management of the retail sales function is high on the bank management agenda and given that the academic literature is relatively silent on these topics we have decided to establish a new work stream that covers the sales and distribution of retail financial services.

1.2 Objectives

Our overall goal over the next three years is to develop clear-cut scenarios of how the European banking business will evolve in the future. The focus will be on the German banking market. By analysing specific elements of the value chain we ultimately aim to devise ways for different types of banks to enhance value creation in this area.

In 2003, we laid the foundation for achieving the overall goal by screening existing work, by doing primary empirical research, by conducting interviews with experts from sponsor firms and from external institutions and by theoretical reasoning.

In 2004 we have been building on the results achieved in 2003. At the end of 2004 we will have produced 11 journal publications, articles and book chapters. Another 6 papers will have been presented on national and international conferences. In addition 4 papers will be submitted to international conferences.

In 2005 we will continue to diligently produce relevant and novel research output. The number of publications and presentations will almost certainly exceed 2004 numbers.

As was the case in the past, we will continue to involve representatives from sponsor firms into insight derivation through joint studies and workshops and through the supervision of dissertation theses of external PhD students.

2 PROJECTS

We divided our work in three working packages with each addressing one selected aspect of value creation in banking. While work streams 1 and 2 concentrate on the cost side of banks and possible improvements of the processes including the extent to which the service is produced internally, work stream 3 has a clear revenue focus.

2.1 Work Stream 1: The Banking Value Chain

Due to increased cost pressure and diminishing revenues banking organizations need to change and adapt their future business model. Work stream 1 tackles several issues implied by these demanding challenges. How do capital markets react when large banking organizations announce to outsource parts of their traditional in-house business? What is the impact on a bank's bottom line (i.e. performance) if the organization becomes less vertically integrated? What are the drivers behind a specific decision to outsource dedicated business processes (i.e. Human Resources)?

- 2.1.1 The first subproject identifies how capital markets react to outsourcing in the financial services industry. This project is an extension to a project performed in 2003/2004 with an increased data sample
 - 2.1.2 The second subproject builds on the results of 2.1.1 and identifies success factors (or specific sourcing-deal characteristics) that lead investors to react in a specific way once they know about a certain transaction.
 - 2.1.3 Subproject 3 aggregates the output of 2.1.1 and 2.1.2. We aim to submit the results to an international top journal
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- 2.1.4 Subproject 4 focuses on the sourcing strategies for one specific business functionality, namely Human Resources. We have sent an extensive questionnaire to global banking organizations and a control group of large industrial firms. We will produce an extensive final research-report and a short version to be published in an academic journal.
- 2.1.5 Subproject 5 comprises of 1-2 clinical studies on banks that have outsourced an administrative function to an external service provider. We aim to derive the key ex ante and ex post determinants of successful outsourcing projects.
- 2.1.6 Subproject 6 deals with the interrelationship of outsourcing and vertical integration of bank organizations. By means of large-sample panel regression we will analyze how the level of vertical integration affects bank performance.
- 2.1.7 After analysing vertical integration and its consequences for the bank performance we also want to look at the impact of horizontal integration (diversification). We want to analyze the common phenomenon of conglomerate discount which leads to a lower valuation of diversified companies in comparison to focusing firms.

2.2 Work Stream 2: Credit Process Excellence

Technological and regulatory changes imply a new business environment for the credit business. Banks trade credit risks, establish risk-adjusted pricing and automate their back-office processes. This work stream identifies state-of-the-art credit lending processes and analyzes special aspects of the credit value chain. Our goal is to analyze how banks can increase value creation in the credit business and to describe scenarios for the credit business of the future.

- 2.2.1 The first subproject aims to identify best-in-breed credit processes. In the first half of 2004 we sent a questionnaire (jointly with cluster 1) to the top 500 banks operating in Germany concerning their credit processes (status quo, state-of-the art, strategic alternatives, long-term vision). Our goal is to identify benchmark cases and measure profitability differentials. Finally, we will define future scenarios and migration paths.
- 2.2.2 Building on the results of the benchmarking study, we will commence to analyze critical success factors in the credit process on a case-by-case basis. We will conduct several clinical studies with banks that have been found to possess excellent credit processes in order to fully understand the underlying mechanisms that lead to competitive advantage in this area.
- 2.2.3 In subproject 3 we will finalize work those work packages that were launched in 2003/2004. We will submit existing working papers on multi-bank loan pool contracts and internal & external rating systems to refereed academic journals. We reckon that the revision process will be finalized in early 2005 and that the articles will be published shortly thereafter.

2.3 Work Stream 3: Customer Behaviour and Financial Services Distribution

Retail-bank customer satisfaction is allegedly lower in Germany than in many other countries. Some observers argue that the same is true for average client-facing time of bank staff, sales process efficiency and cross-selling ratios. As a consequence, many German retail banks are currently seeking ways to streamline their sales and distribution activities. For that purpose, the banks aim to optimally configure these activities alongside the dimensions customer segmentation, product offerings, price differentiation, multi-channel management and incentive schemes for their client-facing staff. In this work stream we want to provide a thorough overview on the current status of academic thinking in this area. We strive to extend the finance-related literature in selected areas and thereby provide guidance for banks' change initiatives.

- 2.3.1 Subproject 1 will summarize the literature on financial services marketing and distribution and identify voids to be filled by our own future work. For that purpose we will also screen the literature from related domains such as services marketing and behavioural finance
 - 2.3.2 Subproject 2 will analyze empirically price sensitivities of customer segments with respect to consumer loans. In contrast to industry standards for loans to the enterprise sector, only a few banks have started to discriminate prices on consumer loans based on customer characteristics and local market structure.
 - 2.3.3 New research shows theoretically that success in retail service delivery hinges on the strategic fit between customer segmentation, incentives schemes and process implications. In subproject 3 we strive to adapt existing models to the financial services context and analyze their practical implications empirically. Ultimately we want to devise ways how retail banks can
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generate additional revenue by optimizing the management of their sales and distribution function.

3 CO-OPERATIONS OF CLUSTER 4

In 2005 we plan to continue with the excellent working relationships that we have established with other clusters of the E-Finance Lab and our sponsor firms.

3.1 Co-operations with other Clusters

In **2004** we have undertaken the following joint projects with other clusters:

- Questionnaire “Credit process excellence”, final report and several publications in academic and practitioner journals (jointly with Cluster 1)
- Outsourcing and operational risk – the capital market’s perspective, joint paper with Heiko Gewalt, Cluster 1
- Integrated decision model for credit product outsourcing, joint paper with Markus Lammers, Cluster 1

In **2005** we will finalize the joint projects launched in 2004 and cooperate with cluster III on customer-centric bank valuation and price differentiation.

3.2 Co-operations with Tier-1 and Tier-2 sponsors

In **2004** we have undertaken the following co-operations with our sponsors:

- Accenture: “HR-Outsourcing survey”, questionnaire design, compilation of raw data, first results
- Deutsche Bank: “Optimal pricing of consumer loans”, literature survey, primary research
- Deutsche Postbank: “Management of distressed debtors”, joint study, journal article
- IBM: Questionnaire and reports “The future credit chain”
- DAB bank: “Banksteuerung”, seminar with speakers from DAB-Bank in Riezlern (June 2004)

In **2005** we are planning the following co-operations with our sponsors:

- Accenture: HR-Outsourcing, Questionnaire, final report, journal article
- IBM: “Credit process excellence”, final survey report, journal article
- Siemens: Workshop “Credit factories”, workshop materials and proceedings

4 WORK STREAMS – PROJECTS IN 2005

By default, we strive to present every research output that we produce on international conferences and publish final versions of each subproject in reputable academic and/or practitioner journals.
