

Cluster 4 in 2006

“Reshaping the Banking Business”

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 two years: “What are the evolving, optimal boundaries of banking firms?”

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. Furthermore, we want to analyze the impact of vertical and horizontal integration vs. diversification on bank’s success. **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 researchers 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 and 2004, 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. We sent out two empirical questionnaires and published first results of our work in several journal publications and conference presentations.

In 2005 we have been building on the results achieved in previous years. At the end of 2005 we will have produced 8 journal publications, 11 book chapters or working papers and 3 practitioner articles. Another 3 papers will have been presented on national and international conferences. In addition 3 papers will be submitted to international journals and 4 to international conferences.

In 2006 we will continue to diligently produce relevant and novel research output. The number of publications and presentations will be steady to 2005.

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. Looking at vertical integration we will continue to research the value consequences of outsourcing and the trend towards a leaner bank. In addition to this we will further intensify the analysis of the horizontal integration of banks. We try to identify which business models are superior and what banks can do to adopt a more successful strategic business mix.

- 2.1.1 The first subproject aggregates findings from prior research (event study regarding financial services outsourcing success and value-influencing factors that determine capital market success of financial services outsourcing) and builds on these results in order to provide a coherent and consistent view of value-determinants that have an impact on investor's decisions once they learn about a financial services firm's intention to engage into sourcing activities. We aim to submit the results to an international top journal
 - 2.1.2 Subproject 2 focuses on structures, processes and sourcing strategies for 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 plan to publish the findings in an academic journal.
 - 2.1.3 Our prior studies on the vertical integration of banks indicate that major problems arise with long-term outsourcing contracts, because the future is hard to predict, some behaviour is not contractible, and some action not observable. Subproject 5 is conducting a scientific case study on governance structures and methods used in outsourcing deals helping to manage these operational problems. We aim to derive a deeper understanding of the problem areas
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and the solution mechanism in use. We hope to give academics insights into empirical problem solving and practitioners an overview of useful tools for their daily business.

- 2.1.4 Subproject 4 deals with the interrelationship of outsourcing and vertical integration of bank organizations. In a first step we analysed the short-term value consequences of vertical integration on return measures as well as on the stock market valuation of a bank. In a second step we try to look at the long-term performance differences of various levels of vertical integration
- 2.1.5 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. In addition we will conduct a long-term performance analysis to identify the factors that lead to a superior performance of diversified banks.

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 extension to the credit process study where the top 500 banks operating in Germany concerning their credit processes we want to measure profitability differentials and identify critical success factors on empirical basis.
- 2.2.2 Building on subproject 1, 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 conduct a complement to the credit process study. In the second half of 2005 we will send out a questionnaire to 500 small and medium size entities (SME). We want to ask for their perspective of the credit lending processes of German banks. Our goal is to identify rooms for improvements for banks to increase the satisfaction of their customers and process efficiency.

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. As of June 2005 we have 1) screened the relevant literature 2) finalized a study on customers' price sensitivity for consumer loans, 3) written a conceptual paper that discusses the implications of typical behavioral anomalies of retail investors on the design of sales and advisory processes. Looking ahead we plan to conduct the following subprojects:

- 2.3.1 Subproject 1 investigates the determinants of customer satisfaction with banks' sales processes. To that aim we conduct a survey among more than 5000 customers of German retail banks. The questionnaire asks for customer satisfaction, process design, customer characteristics and behavioral patterns. We strive to infer recommendations for banks of how they should design their advisory services to enhance customer satisfaction.
 - 2.3.2 Subproject 2 identifies best-practice sales processes in retail banking. To that we survey 50 of the largest retail banks operating in Germany. In the first part we ask them how well they are performing along more than twenty key performance indicators. The second part characterizes
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the sales process in place at these 50 banks. Combining the answers from both parts will allow us to identify and quantify key success factors.

- 2.3.3 Subproject 3 attempts to quantify the value of financial advice. We will use panel data on the portfolios of retail bank customers to measure the impact of advisory services on portfolio performance measures (e.g. absolute return, risk-adjusted return, net return after expenses). We will identify advisory styles/process designs that provide the most financial value to customers from a given segment.

3 CO-OPERATIONS OF CLUSTER 4

In 2006 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 **2005** we have undertaken the following joint projects with other clusters:

- Final report "Credit process excellence" and several publications in practitioner journals (jointly with Cluster 1)
- Extensions of the research stream "Outsourcing and operational risk – the capital market's perspective" (jointly with Heiko Gewalt, Cluster 1) has led to various conference acceptances on internationally renowned double-blind conferences (PACIS 2005, GITM 2005, ECIS 2005).
- The paper "Integrated decision model for credit product outsourcing" was published in "DIE WIRTSCHAFTSINFORMATIK", joint paper with Markus Lammers, Cluster 1.

In **2006** we will intensify cooperation with cluster III on work stream 3 "customer behavior and financial services distribution".

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

In **2005** we have undertaken the following co-operations with our sponsors:

- Accenture: "HR-Outsourcing survey", questionnaire, final report, conference presentation, journal article
- Accenture: Conglomerate discount and value creation in universal banking, joint study, conference presentations, brochures, article
- IBM: Questionnaire and reports "The future credit chain", joint article published.

In **2006** we are planning the following co-operations with our sponsors:

- Accenture: Channel strategies for autobanks, supervision of dissertation, workshops, joint papers
 - BearingPoint: Financial services distribution, supervision of dissertation, workshops, joint papers
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