PART I

THE ENVIRONMENT

Contents

CHAPTER 1

INTRODUCTION

At the beginning of the twenty-first century, the financial services sector is going through an enormous and dramatic process of change. The institutions involved in providing financial services are being rocked by new competition, both domestically and internationally. Citibank, once the leading United States commercial banking institution, is now Citigroup, a diversified stockbroker, insurance underwriter, financial advisor, and finally still a commercial bank. This possibility was simply not allowed under US rules until the beginning of the new century – and now the gauntlet is down for further financial institution consolidation and convergence. The Hongkong and Shanghai Banking Corporation (Hongkong Bank, or HSBC) has metamorphosized from an Asian giant to a global financial services provider, with its headquarters now in London and with a huge US network of affiliates, based on its acquisitions of Republic Bank of New York, Marine Midland Bank, and other smaller institutions. And even insurance companies are finding it necessary to enter other financial services in a major way – witness the acquisition by Allianz of Dresdner Bank, Germany's second largest, and its rapid global expansion through acquisitions of insurance companies in the Americas and Europe.

The definitions of financial services themselves are changing, as electronic methods replace people and physical documentary activities. Internet banks have not replaced traditional ones – but Internet-based banking services are now necessary for large competitive banks to stay in the game against their technology-driven rivals. This volume tries to make some sense out of the rapidly evolving sector and the competition within it.

The current chapter sets the stage. First, it answers the question: What does the financial services sector do? Next, it describes the current structure of the sector, so that competitors, partial competitors, and even noncompeting groups can be seen in the proper context. With these bases in place, it is possible to interpret the technological, legal, and strategic changes that are shaping the new environment.

WHAT ARE FINANCIAL SERVICES?

What is it that banks, stockbrokers, and insurance companies – among other financial services providers – do that creates the "sector"? Traditionally, we think of the two sides of financial intermediation: namely, (1) taking in people's savings and giving them financial claims such as time deposits that reward them for giving up the current use of those savings; and (2) providing financing to people, firms, and governments who want to invest in activities that will enable them to pay back the financing (plus some charge for the use of the funds) in the future. These functions clearly are necessary in any society that advances beyond exchanges based on barter, and commercial banks have generally provided such functions during the past two centuries.

A third category of financial service is the use of money or other financial instruments to realize payments for purchases of goods and services. One of the classic justifications for the use of money[1] is to provide a clear and manageable means of exchange – to set prices of different items and to carry out payment when purchases are made. Thus the financial services sector provides the means of payment (money and its correlates) and the mechanisms for carrying out that payment (such as electronic transfers, checks, and smart cards). In most societies, a main institution such as a central bank is given the role of creating money (cash), and then financial institutions such as banks and others are able to take the initial money supply and move it around, change its form, and generally leverage it to provide the various additional financial services that we know. However, the starting point is the creation of the money and its insertion into the economy.

One could debate the significance of the central bank's role in creating money, versus alternative mechanisms that could be imagined. That would take the discussion too far from its intended focus on the near future, the first decade of the twenty-first century, which is our target time frame. Instead, the discussion focuses on the financial services sector with central banking as a given – though even here the issue is interesting, given the direction of many countries to create new joint central banks (in the European Monetary Union, for example), and thus to shift the money creation activity from a national function to a multinational one. Again, we will begin here with the assumption that a central bank produces new money, and that it is the role of the financial services sector to mobilize that money and optimize the benefits from it.

The third role of the financial sector in dealing with this money is thus to mobilize it for payments of purchases of goods and services. This means offering users the ability to make purchases and receive payment for sales in an efficient, low-cost, and low-risk manner. Toward this end, financial sector participants have developed checks, wire transfers, credit, debit and smart cards, and various other instruments. This can be considered the payments mechanism of the economy.

A fourth role of the financial services sector is to provide guidance to savers on the use of their savings, as well as to investors on their sources of funding. This service ranges from the advising itself to the provision of asset management and treasury management, and additional services beyond. Both investment advising and asset management have grown to be enormous industries on their own in recent years.

Finally, a fifth role of the financial services sector is to provide risk management to both savers and investors. Traditionally, risk management meant insurance – of buildings, workers' lives, and property. Today, the scope of risk management has broadened greatly, to the point of including property, casualty, and life insurance; financial derivatives to manage price, interest rate, exchange rate, and even credit risks; portfolio design to mitigate risks; and even self-insurance.

The sum of these parts thus defines the financial services sector as the provider of:

1 Mechanisms/instruments for savers to store their savings.
2 Mechanisms for investors/borrowers to find funding for their projects.
3 Mechanisms for carrying out payments.
4 Advice and management for savers and investors to deal with their financial needs.
5 Mechanisms for managing and protecting against risks.

In a schematic view, the set of financial services can be grouped as shown in figure 1.1, which lists some of the instruments that are used to provide each type of service, as well as showing the links of the services to the relevant users.

These are the areas of financial service that must be covered by institutions in the sector. The questions for the future are: What kinds of institutions and instruments will they be? Which ones will provide what services? And how will the services be provided? Before trying to answer these questions, it will be useful to take a look at the institutional structure that currently exists in the sector.

WHO PROVIDES FINANCIAL SERVICES?

This question can probably best be answered on a national basis first, and then the global reality can be envisioned from that initial point. The financial systems of the USA, Japan, and Germany are sketched as key examples today.

The United States

The US financial system is comprised of an array of institutions that provide some of the five types of service, but only a tiny number (such as Citigroup, J. P. Morgan Chase, and Bank of America) that provide the whole array of services to a wide range of clients. And only Citigroup is present in a major way in the insurance sector, which was just opened to bank entry in 1999.

In the early twenty-first century, the US financial system is the most developed and extensive in the world. The number of financial services providers and the range of their services exceeds those in any other country – with the United Kingdom in second place overall, and in first place with respect to the provision of some of the

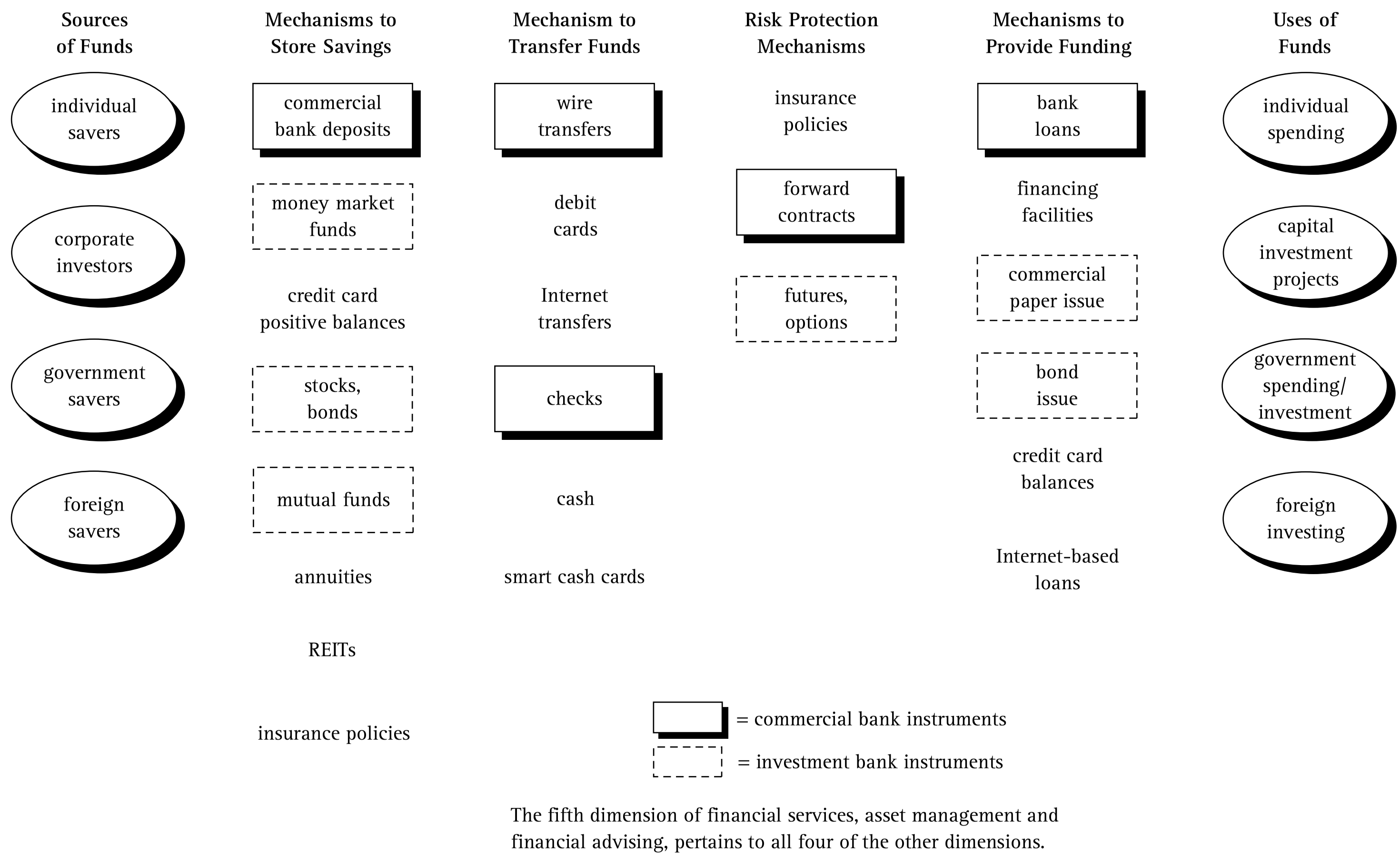

Figure 1.1 The financial services landscape.

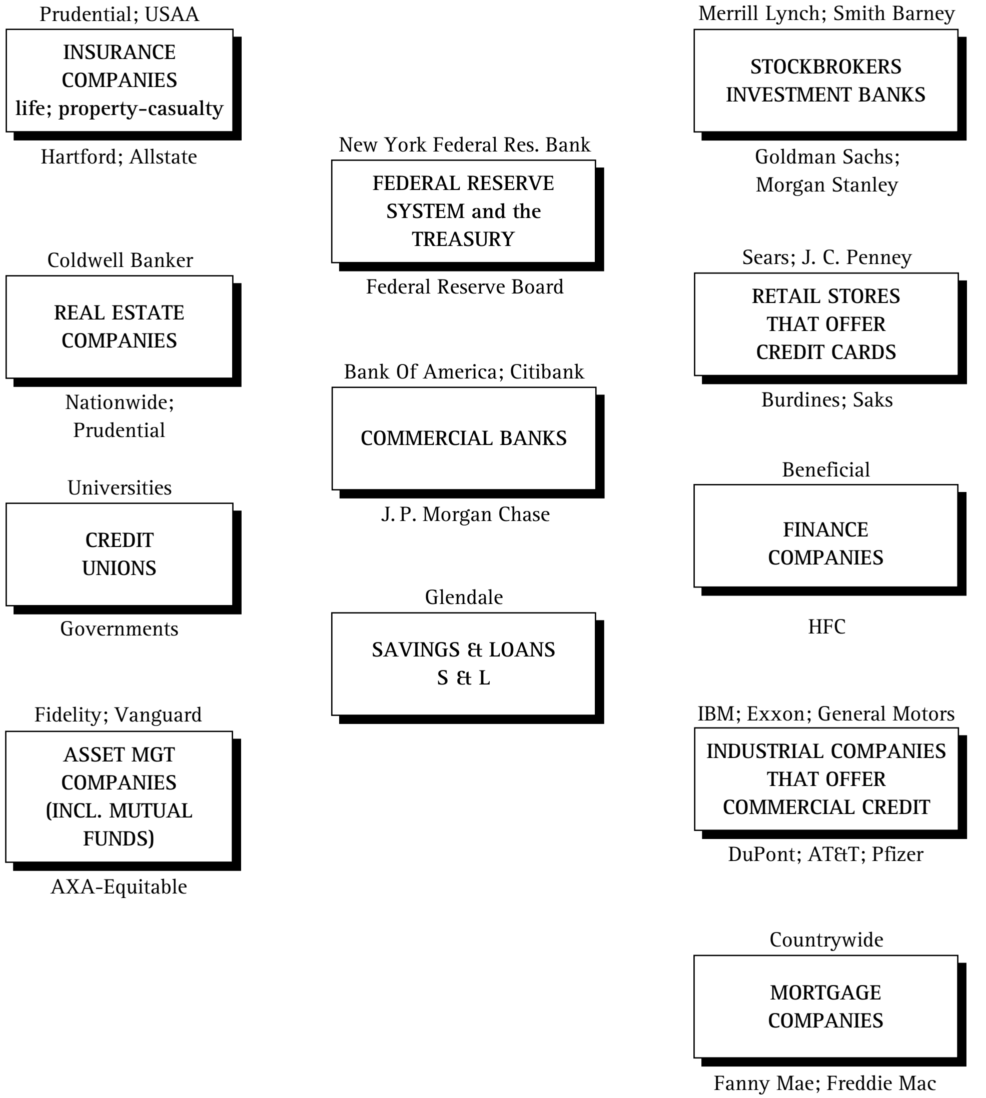

Figure 1.2 The US financial system.

major international services such as foreign exchange, reinsurance, and international bond issuance and trading. The US system has broadened to the point at which banking institutions provide only 20–30% of savings and credit instruments in the economy, with the rest offered by investment banks, insurance companies, fund management companies, and other providers. These service providers and the array of services are described in subsequent chapters.

The US system is shown in figure 1.2 as having a core set of banking institutions, located in the central vertical column and regulated by the Federal Reserve System.

Then, a wide range of additional providers offer further and overlapping financial services, as shown in the major categories listed around the central base. On the right-hand side are listed types of financial services provider that are largely seen as financing sources: investment banks that arrange financing, companies that offer commercial credit to their customers, and specialized lenders. On the left-hand side are organizations that are more oriented toward managing savings, such as mutual fund management companies, credit unions, and real estate companies. These institutions are only the main financial services providers; for every category listed there are even more specialized firms that offer more limited services along the same lines. Overall, the US system is extremely broad in the array of services offered and specialized in terms of the myriad of instruments that are tailored to individual users' needs.

Japan

As in the United States, Japan's government limited the expansion of banks, insurance companies, and stockbrokers into each other's business until the late 1990s. This situation was rather significantly different in reality, since the Japanese firms generally operated within the structure of broad industrial groups, or "keiretsu," which included one or more of each kind of financial services provider in the same group. While the keiretsu remain a dominant force in the Japanese economy, half of the city banks are now not members of a major keiretsu. The structure of the Japanese system, shown in figure 1.3, looks very much like that of the USA, and in the early twenty-first century this appearance has become more of a reality.

The Japanese financial system is based on the commercial banking core, regulated by the Bank of Japan, the Ministry of Finance, and – since the financial crisis of the 1990s – by the Financial Supervisory Agency. This system operates much like the Federal Reserve System in the USA, though with the banks typically involved in cross-ownership and control within the economic groups. The "city banks," with nationwide branch networks, dominate the system. Also key to the provision of financial services are the major securities firms and the deposit-taking Postal Savings system, with its 24,000 branches.

Japan went through a "Big Bang" financial deregulation process in the late 1990s such that, by the end of 1999, insurance companies were allowed to offer banking products, and banks were allowed to operate through subsidiaries in investment banking activities such as stockbrokerage and underwriting. Even with these reforms, an overhang of bad debt remains with most large financial institutions from the bursting of the financial bubble economy in 1991, so that, in the early 2000s, Japan's financial system is quite weak by industrial-country standards.

Germany

Historically, the German financial system has been much less extensive than that of the USA or Japan. In particular, since universal banks have been permitted to offer

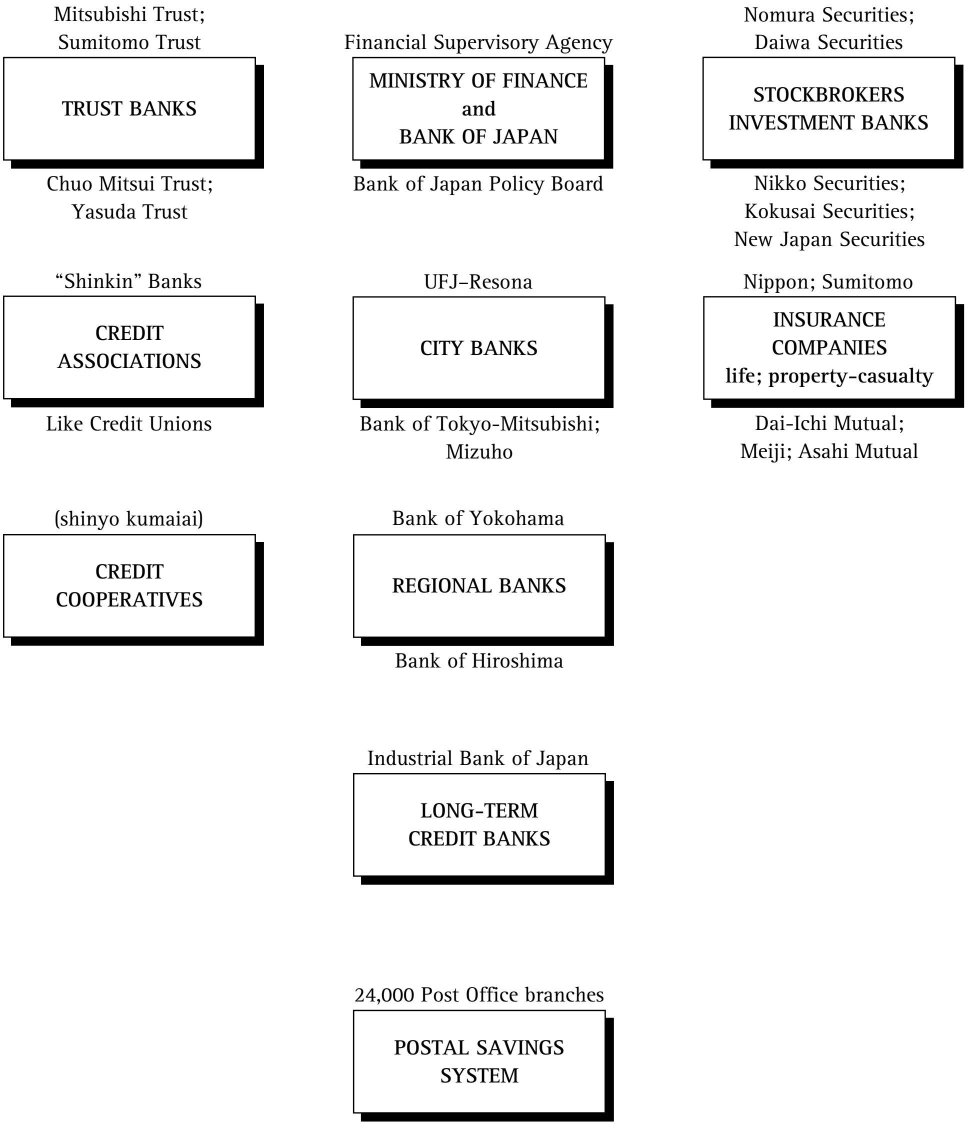

Figure 1.3 The Japanese financial system.

both commercial and investment banking products for many years, the wide range of financial institutions in those other countries is not repeated in Germany. Additionally, with banks allowed to own shares in commercial and industrial companies, the financing needs of some of the major borrowers tend to be serviced by related banks. In overall terms, bank financing provided the vast majority of credit in the German system at the end of the 1990s.

The major change that has occurred recently is the launch of the euro (in January, 1999), the transfer of monetary policy to the European Central Bank, and a general regionalization of financing at the European level. The result of this change is that German companies and other borrowers now have a truly Europe-wide capital market to work with, and additional financing sources are becoming more widely used. Commercial paper and bond issuance, for example, are replacing a significant share of previous commercial bank financing. Still, it should be recognized that the main financial services providers are the main banks – Deutsche, HypovereinzBank, Dresdner, and Commerzbank – through their investment banking as well as their commercial banking divisions.

At the retail level, the main banks face major competition from the Postal Savings system, which enables individuals/families to hold savings accounts and which offers access countrywide at post offices (as in Japan). On the credit side, banks face competition from state-owned banks in each of the German states. The landesbanks have the benefit of state subsidies, and they thus constitute major competitors to the commercial banks – though the landesbanks do tend to focus their financing on long-term and economic development loans. In fact, the landesbanks and local state-owned banks (*sparkassen*) held 38% of the credit outstanding in Germany at the end of the 1990s, so they clearly constitute major competitors for the commercial/ investment banks. Figure 1.4 shows this configuration of the German financial system.

Thus, the response to the question "Who provides financial services?" is that it depends greatly on which country is being discussed. While the move to globalization of financial services is well under way, and some competitors from other major financial centers are present in every major national financial market in the world, the reality is still more national than global. In the USA, insurance products remain to be integrated institutionally within commercial banks (or vice versa). Investment banking products have been incorporated into large commercial banks during the 1990s, and a number of mergers have produced financial institutions that provided both commercial and investment banking services by the year 2000. In Germany, the UK, and Japan, insurance products have been incorporated into financial institutions, though typically through the mechanism of an insurance company subsidiary owned by the same holding company as a parent bank, rather than within a commercial bank itself.

The area of investment management has not been integrated very well into either investment or commercial banking in the USA. The mutual fund companies have created a market segment which they dominate, and which the commercial banks are only now entering significantly. This is not necessarily a huge challenge, since the large banks are much larger than most mutual funds companies, so that – in principle – the banks can buy market share in the fund management segment fairly readily. It remains to be seen, however, how quickly and in what institutional structure this will happen.

The area of risk management has, just in the past few years, become an integrated field, comprising not just insurance products for life, health, property, and casualty

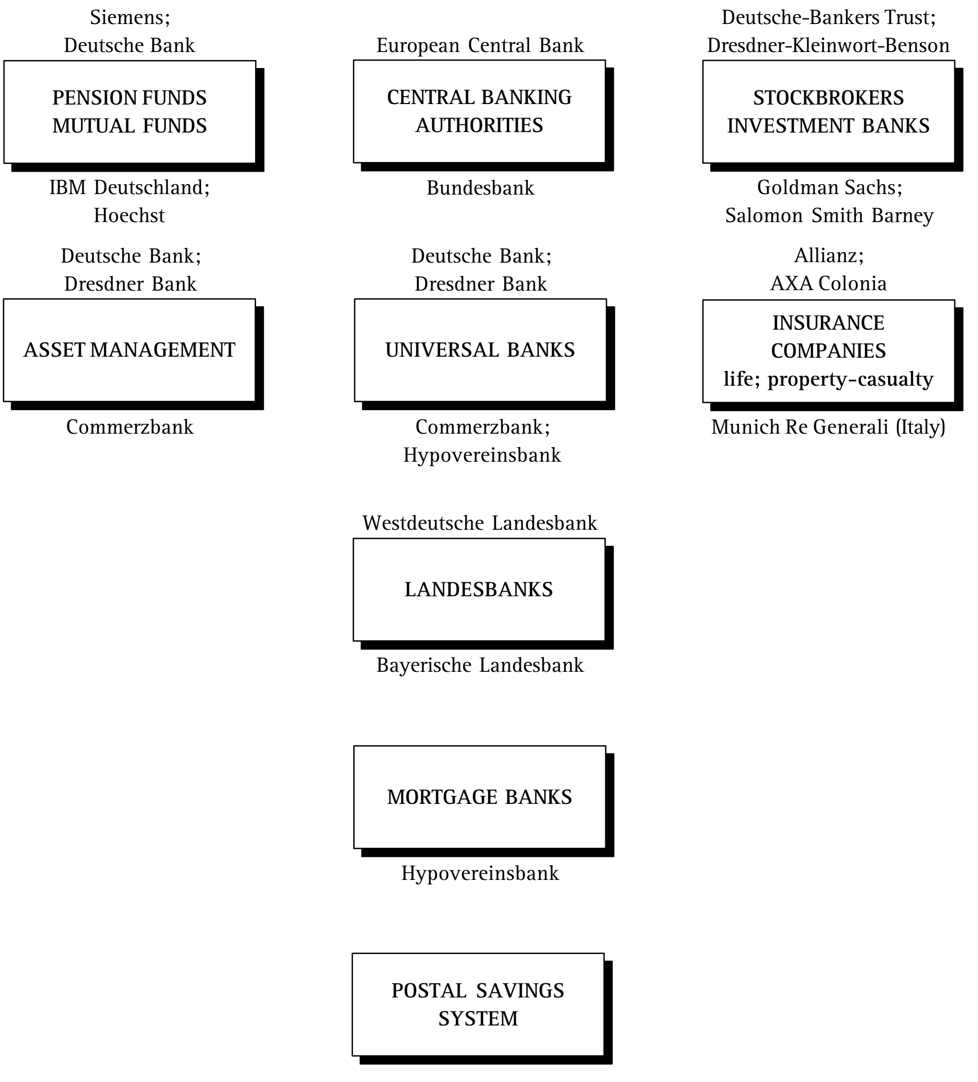

Figure 1.4 The German financial system.

risks, but also products to deal with financial market risks (interest rates and exchange rates) as well as credit market risks. Commercial banks have become greatly concerned about this subject, since the rules for prudent management that are established by national regulatory authorities (typically by central banks) are moving toward a harmonized structure under the leadership of the Bank for International Settlements. And the BIS is pursuing more flexible, risk-based guidelines for capital adequacy determination in commercial banks.

Initial BIS guidelines promulgated in 1988 and implemented in 1993 called for banks to maintain adequate capital against their assets at risk, broadly to achieve an 8% ratio of capital to risk assets. Due to bank complaints about the way that these standards produced insufficient accounting for the diverse quality of various assets, the Bank for International Settlements has proposed new guidelines, for probable implementation in 2005. These guidelines are under continuing review, but the basic principle at present is that commercial banks should be required to establish their own systematic portfolio risk measurement and protection procedures, which then must be explained and justified to authorities. Rather than requiring one single risk assessment and management structure, the BIS guidelines (supported by the central banks) agree that banks' situations may be different among institutions, so an individually tailored risk measurement and management program may be appropriate[2].

The upshot of this reality is that banks are paying much more attention to the subject, and risk management tools and methods are now evolving rapidly. From the basic value at risk measure[3], to more complex schemes, risk assessment and management is creating almost a new market segment in financial services today.

THE CONCEPTUAL BASE OF ANALYSIS

In the twenty-first century as just described, what are the characteristics of financial services providers that will enable them to survive? The building blocks for competitiveness will be labeled "competencies," following the terminology of Prahalad and Hamel[4]. Competencies are business activities that the firm carries out in a manner superior to its competitors, and thus activities that give the firm an ability to compete successfully.

In commercial banking, a competitive edge may be gained by a bank that can provide financial services more cost-effectively than its competitors, or by a bank that can get its services distributed to clients more widely than its competitors, or by a bank that can make clients feel that they are receiving more personalized service than from competitors, and so on. In investment banking, a competitive edge may be gained by a stockbroker that is able to provide less costly transactions to retail clients, or by an underwriter that is able to offer better distribution of securities to corporate clients. In insurance, a competitive edge can be gained by offering a more extensive network of affiliates to sell policies and provide claims responses. All of these advantages are examples of activities carried out by financial services providers in which one firm can establish a competency that is superior to that of its rivals.

Initially, we will look at existing competition among financial services providers, to try to discover the competencies that enable individual providers to survive and prosper. The sectors of investment and commercial banking and insurance are explored. Then attention will shift to the new environment that is evolving today, to try to anticipate the competencies that will be most important in that context.

LEGAL AND TECHNOLOGICAL SHIFTS

The financial services sector is key to the prosperity of nations, and so governments are vitally concerned with the viability of the financial system and with their abilities to impose economic policies through that system. The legal/regulatory environment surrounding the sector is therefore crucial to the strategic direction of banks, insurance companies, and other providers. And it is just this legal environment that has been undergoing radical changes in the recent past, such that competitors are being faced by major new threats from rivals – and by *reduced* limitations from regulators.

On the technology front, the Internet has brought huge changes to competition in financial services, so this mechanism, which provides a channel of distribution of financial products, a means of internal information transfer within firms, and even a new source of competition from "virtual" firms, is explored in some detail.

AN OVERVIEW OF WHAT IS TO COME

The rest of this first part of the book takes a broad perspective on the financial services sector. The next chapter looks at the globalization process that is under way in financial services. After that, the two main environmental challenges to the sector are analyzed: technology changes and regulatory changes. These conditions are the terms of reference in which financial services providers are operating.

The second part of the book looks at competition among financial services providers. First, the array of financial services providers and their relative positions in major markets are described. Next, some of these competitors are described in some more detail, and their broad strategies are sketched. Then an attempt is made to identify key competencies that have enabled financial institutions and brokers to survive and flourish in competition during the recent past. A suggested means for establishing competitive strategy is offered, the idea of Transformational Management.

The final part looks at two of the sector's key businesses – investment banking and insurance – analyzing the existing competition in each one and pointing out the features that are leading toward the future structure of the sector. This section also describes the financial instruments and structures that are defining the financial services landscape, and then looks at some specific issues in this context. One such issue is the generation of long-term investment to support capital market development worldwide. Another is the role of financial centers in the current context of electronic banking and virtual institutions. The final chapter recaps the expected changes in financial services provision that we should see in the next few years, and draws some conclusions about the direction of the sector as the twenty-first century unfolds.

NOTES

1 The three classic uses of money are:
   1 As a unit of value, to denominate all other goods and services in an economy.
   2 As a means of exchange, providing some instrument such as cash to carry out exchanges of goods and services.
   3 As a store of value, such that the money itself, or money transformed into financial instruments, can be held for future purchases.

2 The BIS capital adequacy requirements based on the 1988 agreement are listed at http://www.bis.org/publ/bcbs04a.htm. The proposed new requirements are listed at http://www.bis.org/publ/bcbs504.htm. The new requirements are expected to take effect in 2007.

3 Value at Risk is a concept developed by J. P. Morgan in the late 1980s. The basic measure is the maximum amount that a project or a company/bank can be expected to lose in 99 out of 100 periods (days). See, for example, Philippe Jorion, *Value at Risk*, 2nd edn. (New York: McGraw-Hill, 2000).

4 See C. K. Prahalad and G. Hamel, "The core competence of the corporation," *Harvard Business Review*, 68, May–June 1990.