Academicals Topic

Strategic logic of disintermediation in private banking by Dr. Bernhard Koye

The evolution from an industrial into an information society has significant repercussions for the financial sector. In this article, Dr. Bernhard Koye discusses the issue of the impacts on the value chain in private banking. He also comments on the repercussions of the marketing of financial products and the consolidation of the stock exchange environment from an academical point of view.

At the beginning of the 21st century, private banking is still characterised by a fragmented market structure and an attractive added-value potential. This has been confirmed by a recent study[1]. Private banking, which is of great importance to Switzerland, is becoming increasingly commodified and industrialised. New and forward-looking business models are needed that can maintain the current potential and allow existing structures to be adapted to future circumstances.

Conditions for forward-looking business models

Since the 1990s, our society has been changing from an industrial into an information society. In recent years, advances in information and communication technology have triggered an economic and social transformation often referred to as the information revolution. The information environment, human behaviour and the establishment of business relationships are being restructured as a result of the fast advancement of network technology. At the beginning of the information age, service providers and information-processing sectors in particular were faced with new challenges.

The financial sector is deeply involved in preparing, analysing and interpreting information and performing as an intermediary between the financial markets and clients. Since information is the key resource of the financial sector, the freely accessible Internet constitutes an immediate challenge for the sector's value chain. Since private banking is a major segment of the financial sector and an important part of Switzerland's national economy, these change processes must be examined in detail. Traditionally, the main advantage that private banking had over its clients was better access to information. This advantage is being eroded.

Change is a constant in the life cycles of both individuals and companies. After an adaptation phase that usually requires no cognitive effort, what is new and stimulating becomes an integral part of the individual's world view. In retrospect, the triggers for change processes seem obvious. Looking ahead, however, the challenge lies in recognising incipient change processes and in responding accordingly. At the level of the individual, behavioural adaptation after the fact is usually possible without any major repercussions.

At the level of a company, on the other hand, late adaptation can be lethal. Failure to recognise the signs of change in good time may result in being forced out of the market. An understanding of the basic nature of change processes is an indispensable condition for understanding change and instituting strategically important adaptation measures. "It is not the strongest of the species that survive, nor the most intelligent, but the ones most responsive to change".[2]

Hence, all providers in the area of private banking in the information age are trying to occupy strategic positions that promise success, and they are under pressure to reconsider their positions in view of the likely erosion of their informational advantage over clients in the coming years and also in view of the "commodisation[3]" of important areas of the banking industry.

The core competences of the value chain form the analysis framework for any such review. Each network-age business model is determined by three key parameters: the clients, the abilities of the company and the company's positioning with reference to its competitors.

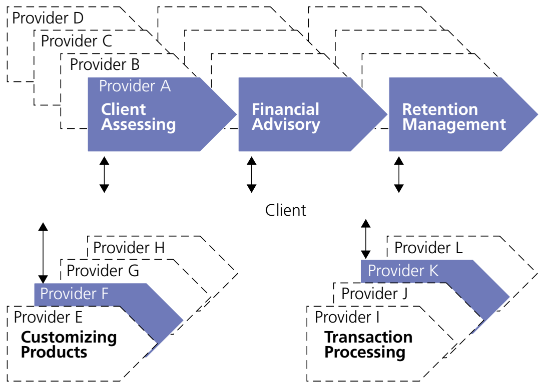
Consequences for the value chain

The vision of networked private banking with a network-based modular value chain implies that greater importance will be placed on outsourcing processes. The value chain in private banking is being disaggregated step by step into the areas of "Customer advice", "Product Offering" and "Transaction Settlement".

1 See Cocca 2005
2 Darwin
3 See Csoport 2001

Integrated value chain

Disintegrated value chain in the information age



The *first component* of each business model is *customer behavior*. Some years ago, results out of the industrial innovation research suggested a radical behavior change in the private banking industry. Argumentation was based on the recognition that customer could reduce their informational disadvantage significantly due the information available on the internet and would therefore force margins to come down. However, this development did not occurred radically. Several initiatives of new business models of online banks in Switzerland did not succeed as they did not attract enough customers. So far, adaptive strategies on the basis of existing business models proved to be successful.

Switzerland's population will have a higher life expectancy and lower birth rates in the coming years, which means that the demand for services in the area of private retirement provisions can be expected to rise. The Internet is used by all generations. The typical Internet-banking client is wealthier and more receptive to new developments than the average. The Internet is viewed as a useful tool particularly in connection with making financial decisions.

Three client types can be distinguished in terms of how they assume responsibility. Delegators (who constitute 25%) have consultants manage all their assets in the context of a mandate. Validators (43%) expect their consultants to involve them in the decision-making process. Soloists (32%) manage their assets themselves. Innovation research suggests that the proportion of soloists will increase in the long term and that the proportion of delegators will continue to decline.

Client segmentation must be geared towards these new conditions and take account of attitudes towards current information and communication technologies. Other deciding factors in connection with any reorientation are higher expectations with regard to best-in-class products, the expertise of consultants, proposed solutions and the possibility of involving affluent clients by means of technology. In future, the success of providers may depend on the ability to anticipate when the number of soloists starts to grow exponentially and on the ability to take account of soloists' needs in today's business models.

In the *product offering area* as *second component* of each business model, so far a lot of providers try to keep selling their own products and will continue to do so as long as margins are interesting enough, but one has to bear in mind that more and more financial products become a commodity. Clients also understand more and more about the banking products and demand Open Architecture, which is why more and more providers are exposing themselves to the forces of the free market and have to make do without direct cross-selling by the relationship managers of their own banks. Therefore, margins are also under pressure. Classical funds products e.g. face the demand of cost transparency these days. Therefore, integrated products like structured products and hedge funds still allow interesting margins as they combine various aspects of the clients needs and are not that easy to understand for the clients. Some providers of structured products and hedge funds have been able to built up a core competence, structuring sophisticated financial products and are therefore able to increase or at least maintain the product margins.

The *third component* of each business model, *transaction settlement*, is a scalable business. Here, a higher rate of return becomes possible if more transactions are being processed. As transaction settlement becomes a commodity, and margins have faced erosion already over the past years. Therefore, different players aim to enlarge the volume through insourcing of other banks (e.g. the UBS AG with a project called "Bank for Banks" or smaller providers such as Märki Baumann as well as actual transaction banks such as the "Xchanging European Transaction Bank"). Many providers consider outsourcing very attractive in this area. The trend towards open architecture in the product area triggered the trend away from regulated product marketing towards free rule of market forces. A similar development in the area of the stock market, a development in which the various stock exchanges become increasingly exposed to the laws of the international marketplace in their fight for better economies of scale and under mounting cost and competitive pressure, is not only possible, but likely in the medium term.

Conclusion

"Change takes a lot longer to happen than you sometimes expect [...]."[4] In the end, humans and their finite ability to absorb information are the limiting factors for further advancements in the area of networks in private banking. The precious resource of time must be used according to subjective individual preferences. Change is considered only when the expected benefit of a new business model is higher than the perceived benefit of an existing one.

The advances of the information age significantly reduce information costs. The easier methods of gaining information that are available to clients in the information age will gradually change the current situation and may erode the edge that banks had with regard to knowledge. This means that the modularisation of the value chain in the medium term is unavoidable. The trend in providers' institutional design of links in the value chain is towards networks.

Theoretical insights into innovation suggest that, in order to help shape the change process, providers must sustain a management culture that fosters awareness of the determining factors of their business models. However, implicit knowledge is required to solve complex problems on the basis of available information. Hence, the ability to provide integrated solutions at the customer interface will be decisive for long-term success. In the area of product development, product factories and/or best-in-class providers can be expected. The continuing consolidation of transaction settlers and European stock exchanges for the purpose of achieving better economies of scale seems unavoidable, as do accompanying massive restructurings.

4 Gates 1997

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