

NEW DISTRIBUTION MODELS FOR FINANCIAL SERVICES: THE ITALIAN BANKS' APPROACH TO THE ON LINE TRADING DEVELOPMENT

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ABSTRACT

In recent years, customers' demands on financial services have changed significantly and the number of customers who engage in electronic commerce for financial transactions has increased considerably in the past years (Business Week, May 25, 1998). Due to the increase in income as well as improved information on financial services, customers are becoming more price-sensitive, more rational in decision-making and thus more challenging to the vendors.

The present analysis is focused on the Italian banking sector; however, some aspects taken into consideration here may be in common with other countries. Porter's five forces model is used to show how the Italian banks could leverage the advantageous cost asymmetries given by their existing distribution channels to pursue simultaneously cost leadership and differentiation, providing the trading on line service. The lack of specific competencies and assets together with a number of tactical and strategical drivers suggests that these new services could be object of outsourcing.

1. Introduction

The paper is divided into 7 sections. Following this introduction, section No. 2 briefly reviews the research of new business models of the Italian banking system. Section No. 3 describes the customers' demands of financial services that have changed significantly and the distinctive peculiarities of the services offered by Internet. Section No. 4 examines the impact of the Web-based technology on financial services distributive channels. Section No. 5 is dedicated to the strategic analysis related to the fact if the Italian banks should look at their potential new role of net brokers as a strategic opportunity or as an unnecessary burden which takes them away from their core business.

Section No. 6 enlightens how to overcome the lack of specific competence and technology recurring to the outsourcing issue. The paper concludes in section No. 7 illustrating the peculiar features of the Italian scenario.

2. The Italian Banking System: The Research of New Business Models

The beginning of the deregulation process worked out by the Banca d'Italia (with the aim to adequate the Italian banking system to the EU market), the evolution of Customer Behaviour showing new and diversified needs for the management of client portfolios and the birth on the market of new operators pointing out an aggressive competition in the offering of new financial products (which is obliging banks to compete in one enlarged market, both for dimension and for demand configuration) are only some signals that the Italian banking system is passing through a phase of deep changes.

Due to these changes, the Italian banks have to adopt new business models and re-design their strategies in order to:

- reorganize the marketing and sale areas, promoting new products and changes in the commercial processes
- define new office roles with an improved consultative orientation and with a deeper service efficiency
- create new distribution channels, especially phone and home banking
- initialize new services like private banking and develop products to diversify savings and investments.

A. The Retail Market

According to the most recent Databank's researches the 25.250 bank offices are still functioning as the main sale channels in the Italian daily life, even though they are losing ground to the new electronic channels (for

example ATM, Self Service...), to the centralized services (phone and home banking) and to the mobile channels such as developers and promoters.

B. The Corporate Market

The Italian banking system has proposed a standard for model for the information exchange (Interbanking Corporate Service). The number of banks adhering to this service are today 140.

Telematic payment services constitute the heart of the corporate banking services and the electronic cash management is assuming particular relevance. This service offers the opportunity to exchange information with the bank or the group of banks adhering to this service.

The total number of Italian companies using these corporate banking services is 120.000. It is estimated that the number will grow significantly when the services – actually using dedicated networks – will be implemented on the Internet.

C. The New Multichannel Model And The Ict Technologies Role

The range of the banking distribution forms is growing rapidly through the traditional channels integrating with new innovative ones that are taking part in the massive use of the Information Technology.

The new multichannel model, which is increasingly becoming the norm in the financial services sector (*Frei F.X. et al., 1990*), is putting the customer in focus: these pretensions optimize the integration between different distribution channels as well as the range of products offered resulting in the change of the traditional market approach.

The Italian banks, characterized by high costs and a big incidence of the not much remunerative traditional services, must necessarily face the upcoming restructuring and use the new telematic services.

Even if there are some successful multichannel cases (Cariplo, Banca 121, Carifirenze, Cariverona) and new banking initiatives focusing on the employment of Internet (like Onbanca, the virtual bank of the Popolare Commercio e Industria Group), the sensation is that the Italian multichannel banking model should be still invented.

3. Using the Net for Financial Services

From the user point of view, Internet is emerging as a new distribution model for a multitude of new products and services, and clients are even more oriented to implement financial transactions using the net.

Moreover, it has also to be considered that a propulsive push to the use of Internet in Italy should be given by the promotion offered by the most famous cybermarket players, as Tiscali, Infostrada, Wind and Telecom Italia Net, to present the customer with the access to the net.

We start talking of “virtual finance”, using this term to express the use of the net with financial aims. But it should be very restrictive talking of virtual finance and meaning with this term only the financial transactions happening daily on the Web. This phenomenon is bigger than this, and includes not only all the information supporting the financial decisions which are easy to find on the Web at a low price, but also all the sites having educational purposes in financial topics and other more innovative aspects peculiar for the net, like financial *newsgroups*.

The on line trading offers a lot of advantages, including the possibility to realise transactions 24 hours a day, low costs, the access to a vast amount of information and the opportunity to access to your own account wherever you are. Suddenly the humblest online investor now has access to services that traditional brokers previously limited to their wealthiest client, such as research and comprehensive price information in real time.

In the management of new financial instruments there are some factors of strategic relevance. Between these ones, the possibility to have information in real time (or before the others) and to interact rapidly on the markets. Actually these ones are characterized by a great volatility: buying or selling late, in respect of the circulating news or to an intuition, can only be translated in profit reductions, or in losses. These peculiarities given, it is appeared immediately obvious as the application of Internet to the finance should be really useful.

The distinctive peculiarities of the services offered reside essentially in the fact of:

- they allow a high speed in the transfer of orders in the sphere of few seconds - also in the high traffic moments during the Stock Exchange closure;
- there is an extreme transparency and rapidity in producing documentation of transactions, which is updated on line in real time after each operation;
- the systematic choice of effective and well tested informatic technologies allows high safety and reliability for each transaction;
- transaction costs are the lowest both on the Italian and world scale because of the big volumes and the total process automation.

4. The Impact of the Web-Based Technology on Financial Services Distributive Channels

From passive instrument aimed to reduce the costs and to rationalize the internal procedures, technology is assuming a fundamental role in the new competitive scenario where financial brokers act, becoming an innovative and dynamic factor for banks and a propulsive force enabling the born of new techniques, new products and also new markets (*Porter M.E., 1985*). In particular, technology should also be considered a winning weapon in the fight for the customers' acquisition and fidelization. The management becomes more and more conscious of the importance of the IT role, which, from simple functions' support inside the banking organization, is becoming an instrument used to radically modify the strategies and the organization itself, assuming the role of critical variable. Technology leadership in financial services firms becomes a significant variable that enhances organizational knowledge and improves overall service quality in the eyes of the customer (*Roth A.V., W.E.III Jackson, 1998*).

Actually IT and Telematics offer to the bank the chance to obtain advantages compared to the competitors in terms of improved operative efficiency, through operations aimed to realize a competitive cost structure and the joining of scale economies and flexibility (*Rockart J.F. et al., 1996*).

Referring to the transaction costs, a Booz-Allen-Hamilton's survey (1997) indicates that the cost of a banking transaction to the branch is higher than a similar transaction through alternative channels (Fig.1).

CHANNELS	COST IN \$
Traditional Branch	1,07
Internet	0,010
Phone	0,54
ATM	0,27
Pc and Proprietary Software	0,015

Figure 1. Transaction costs (Booz-Allen-Hamilton, <http://www.bah.com>,1997)

From another point of view, technology can be used to pursue strategies based on the differentiation and expansion of the services offered and is aimed to give the financial institutions a precise image recognized by the sector.

IT - acting on the accuracy and rapidity of the processes and on the communication forms with the market - permits a wider adaptability of the services offered by the bank to the specific customers' needs, and promoting the integrated offer of a big range of services, it can contribute to the achievement of higher qualitative levels than the competitors (*Porter M.E., 1980*).

The so conceived IT has to become a real strategic lever able to manage the changes through the redefinition of the banks' distributive model, and it's particularly through the net technologies that banks can join their customers individually, marking the service and realizing deep changes in the nature of their competition. Customer Satisfaction does not mean just prompt, courteous service; it also means designing products and services to meet individual customer needs (*Rockart J.F. et al., 1996*). In this way, the exploitation of the Internet technologies becomes a Critical Success Factor.

A question not necessarily confined to the Italian experience, naturally raises: *how should the banks react to this environmental change?* Should they look at their potential new role of net brokers as a strategic opportunity or as an unnecessary burden which takes them away from their core business?

The following section applies the well-known Porter's five forces model to try to give an answer to the question.

5. Strategic Analysis

This study is focused on the Italian financial sector which has some specific characteristics, both from the legal and the economic point of view. It is built on the well-known basic conceptual framework introduced by Michael Porter (*Porter M.E., 1980*) and applied to the Italian financial sector. For an overview of the relevant contributions on this subject, see Cecilia Rossignoli (*Rossignoli C., 1997*). Some of the aspects indicated below might be generalized to other countries, especially to the European countries that show similarities on the financial markets. Another interesting issue, not addressed here, would be to find out if the main conclusions would be different for other countries.

Is it of interest for Italian banks to offer financial services on the net? We can regard this potentially new activity as a new service that the banks could offer to their customers. Porter's five forces model helps us to understand the strategic issues related to this question. The model is depicted in Fig. 2 and it's generally used for an

industrial sector analysis. Here the focus will be specifically on the virtual financial services; the analysis will be broadened in the following sections.

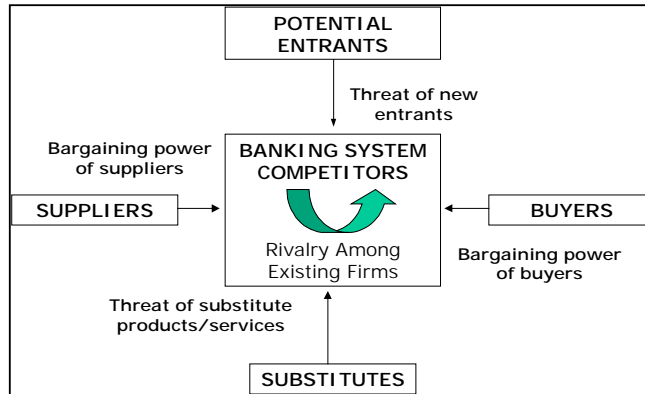


Figure 2. Porter's five forces model, adapted from Porter M.E., 1980

A. Potential Entrants

There is a significant entry barrier for the financial on line service, which is, to use Porter's words, the "access to distribution channels" (Porter M.E., 1980).

Another entry barrier which is peculiar in Italy and could be defined as a "cost disadvantage independent of scale" is given by the requisites stated by the Italian law and regulations. "The obligations are so formed that the access to the role is restricted to particularly solid economical subjects, [...] and the banks are the first ones to be considered" (translated from De Andreis P., 1999).

B. Substitutes

Potential substitutes should be considered Virtual brokers (as shown in Fig. 3), credit unions, and others.

BROKER	URL
Schwab	www.schwab.com
E-trade	www.etrade.com
Fidelity	www.fidelity.com
Datek Online	www.datek.com
DLJ Direct	www.dljdirect.com
Quick&Reilly	www.quickreilly.com
Ameritrade	www.ameritrade.com
Others	

Figure 3. Main on line brokers

C. Bargaining Power of Buyers

The on line trading service buyers' power is presumably quite high because of the low buyers' switching costs, the standardization of the service and the low direct profit presumably generated by low pricing policies

D. Bargaining Power of Suppliers

The on line trading service is based on an important technological infrastructure. The service requires a specific knowledge, specific skills and a specific technology, which are not typically present in the Italian banking structure. The main consequences are that the dependence on technology suppliers would be high and that important investments aswell as organizational efforts should be faced. As enlightened in the next section, outsourcing could be a good way to overcome these types of difficulties.

E. Rivalry among competitors

At present, there are few active competitors in Italy for the virtual financial services sector. A viable option for the banks, discussed in next session, might be outsourcing the technology services. On this service, there might be a competition among banks and a competition between banks and other actors. Outsourcing could lower the exit barrier given by investments in technology. On the other side, the entry barrier formed by access to distribution channels could be determinant in the competition between banks and other institutions.

F. Generic Strategies: cost leadership/differentiation

In the analysis of the five competitive forces given above, one of the key aspects is the availability of the bank traditional distribution channels. With the massive usage of IT and of alternative distribution channels, the banks could have difficulties in finding a way to reduce costs associated with the branch structure, facing important strategic risks, which are named in a recent report by the European Central Bank “*worsening excess capacity problems and unsustainable cost structures*” (European Central Bank, 1999, pag.35). On the other side, to build up this service, important investments and organizational efforts would be required by non-banking actors, even if the choice would be made to build up a hierarchical service network in conjunction with other affiliated entities. From this point of view, the ready availability of their own distribution channels may enable the banks to point to the cost leadership for the trading on line service, and to reduce the excess capacity. Moreover the banks may differentiate themselves from other eventual non-banking competitors. A strong brand name could be leveraged as well. The presence of an advantageous cost asymmetry in the distribution of the service is often balanced by the lack of specific competence and IT assets, which has to be overcome. The (usually rare) coexistence of cost leadership and differentiation in the trading on line service might move the banks to be aggressive, offering it in bundle with their core business services, setting competitive prices and gaining further indirect advantages.

How can the Italian banks further leverage the aspects evidenced above to gain a competitive advantage and improve their competitive position in the financial sector?

6. Outsourcing the Service

The continuing growth of new potential services provides Italian banks with the opportunity to re-assess the question of which activities should remain in house, and which activities should be sourced from outside, whether by purchase or through forms of cooperative agreement (Jennings D., 1996; Currie W., 1995). Quinn and Hilmer (Quinn J.B., Hilmer F.G., 1994) suggest ways to answer to the question. Two new strategic approaches, when properly combined, allow managers to leverage their banks' skills and resources for increased competitiveness:

1) *Concentrate the bank's own resources on a set of “core competencies”* where it can achieve definable preeminence and provide unique value for customers (Quinn J.B., Doorley T.L., Paquette P.C., 1995)

2) *Strategically outsource other activities* – including many activities considered traditional integral to the bank – for which the bank has neither a critical strategic need nor special capability (Quinn J.B., 1992).

If we apply these approaches to a typical Italian bank issuing the trading on line service it appears immediately clear that this is usually not a core service. It does not represent a critical strategic need and the bank is not provided with the special capabilities to offer this kind of service (it does not own the technology leadership).

The main effect is the start up of a real “financial services industry” and the companies supporting the competitive position of the banks and the related sectors in this respect are part of a segment called Business Process Outsourcing like e-Financial Services Outsourcing (e-FSO). These companies, contacted by the banks, offer a vast amount of services and software solutions enabling traditional suppliers of financial services (banks and credit unions) to use Internet as a dynamic additional distribution channel in order to:

- remain competitive;
- retain the customers;
- offer new services;
- expand over the traditional geographic borders.

The e-FSO providers were traditionally focused on vertical markets like the retail banking and on particular segments of the market as little/medium banks, but as markets are growing, the e-FSO providers are enlarging their customers base in order to include other markets as e.g. corporate and small business.

According to the results of a recent survey from “The Outsourcing Institute”(The Outsourcing Institute web site: <http://www.outsourcing.com>), behind a bank decision to outsource the trading on line service, a number of drivers can be individuated: some of them are tactical, others are strategical.

Tactical reasons to recur to the outsourcing are based on the following facts:

1) *It reduces operating costs.* An outside provider's lower cost structure, which may be the result of a greater economy of scale or other advantage based on specialization reduces a bank's operating costs and increases its competitive advantage.

2) *Some resources are not available internally.* New organizations, spin-offs or banking expanding into new geography or new technology should consider the benefits of outsourcing from the very start.

On the other hand, the strategical reasons are:

3) *It improves bank focus.* Freed from devoting energy to areas that are not in its expertise the bank can focus its resources on meeting its customers' needs.

4) *It accelerates reengineering benefits.* Reengineering aims dramatic improvements in critical measures of performance such as cost, quality, service and speed.

5) *It allows the access to world class capabilities.* World-class providers make extensive investments in technology, methodologies and people.

6) *It reduces risk.* Markets, competition, government regulations, financial conditions and technologies all change extremely quickly and outsourcing providers make investments on behalf of many client, not just one.

7) *It frees resources for other purposes.* Outsourcing permits an organization to redirect its resources from non-core activities toward activities that serve the customers.

Swamidass (*Swamidass, P.M., 1993*) suggests that an evolutionary process in global sourcing consist of three stages: cost minimization, competitive advantage and strategic asset. As customer satisfaction is becoming a central lever for the business tactics, competitive advantages of the Italian banks focus on the ability to create a major value for the customer in terms of quality, service and product innovation. In this study, these three stages are joined together since a bank - externalizing the trading on line services - could simultaneously minimize the costs, gain and sustain competitive advantage and join the strategic asset.

7. The Italian Scenario in the “Virtual Finance” Sector: Some Cases

It was on September 1995 the first time Italian banks appeared on the net: in a time period of 15 days, from September 10th to 26th, six banks appeared on the Web. The first one was Cassa di Risparmio di Firenze, followed by Banca di Credito di Trieste, Banca Popolare dell’Etruria e del Lazio, Banca di Roma, Cassa Rurale di Molina di Ledro (Trento) and Banca di Credito Cooperativo di Faenza (Ravenna).

Since February 1996 Italy has assisted to a small but constant growth of the presence of the banks on the Web; after this, there’s been a great upswing, and from February to June the operative Web sites passed from 36 to 79. On December the same year quota 100 has been reached. Data collected on July 1999 indicate the presence of 277 on line banks in Italy: about 1/3 of the whole banking sector is today reachable via Web.

And between the most innovative home banking dispositive services is taking ground the possibility to perform transactions regarding financial instrument via e-mail (*M.S Krishnan et al., 1999*). In the middle of July only 4 banks offered this type of service to their customers (Cariplo, Banca Sella, Monte dei Paschi di Siena, Cariverona). However, at present there are a lot of banks ready on the starting line.

In Italy since July 1998 the law did not allow the offer of shares on Internet and it did not exist a specific regulation about the telematic financial market: this is the reason why an Italian investor who wanted to use this kind of service for the transactions in shares should necessarily address his request to a foreign on line broker.

And finally the Consob official recognition: “*The Commission, with the communication n. DI/98063298 dated 30/07/98, expresses on the possibility given to the financial broker to receive and orders through the net*” pointing out that this new way of offering the service is only admitted “*in reason of the wide discretion in defining the modalities to carry out their activity that the discipline of the sector gives to the authorised brokers*”.

In the last three year, with the fall of the interest rates of banking accounts and the Bond offered by the State (in particular BOT and CCT), Italian savers are looking with major interest to the new financial markets, passing from the fixed-income securities sector to the capital of risk one: the boom of the diversified investments disclosed before all in the Stock Exchange and in the success of ENI and TELECOM privatization, and then it’s concerned the global investment funds, whose subscription have been multiplied by ten in only 1 year. The birth of the Italian Derivatives Market (IDEM) in November 1994 assumes a big relevance. Besides representing an important instrument for the liquidity of the exchanging market for the professional investors, it has called the attention of that band of small savers needing some instruments for covering the risk coming from the financial profile of their portfolio, towards instruments like option and futures.

Between the Italian realities to set going the stock transactions via Internet, the most relevant cases are Fineco SIM (company of the Banca Popolare di Brescia Group) and Directa SIM. Data collected in 1999 point out an exponentially growing trend and the confirm of the national leadership demonstrate as a start-up company in the on line trading sector should be also profitable from the first year of life denying the common idea that Internet activities generate only red sheets. Actually, in 6 months only, Directa’s customers are growing at a 300% rate and the intermediated funds are going over 1,500 thousand million lira, against 1,057.9 of the whole 1998; on June 1999 Directa’s customers enter an order on the telematic market every 6 seconds.

First, also on the world scale, Directa introduced at the end of May, the GSM Trading ®, allowing investors to buy and sell quotes using simply a GSM mobile.

It’s enough that the Directa’s customer has a mobile with Internet access and everywhere he is, in the GSM covering area, he should be connected to the Directa Internet site and buy and sell quotes on the telematic exchange rate in few seconds, like using the home PC.

Moreover, Directa's web site offers an optimised version in order to permit an easy navigation with the mobile's keyboard and a clear reading of the pages on small displays. Using familiar interfaces, the customer can access the whole Directa services: read on line quotations of the stocks, visualize MIBTEL trends, put and revoke orders, visualize their updated position (in lira and quotes) and access to their account in every moment, also over the Stock Exchange opening time.

Really complete is also the service offered by Mediosim (Mediocredito Centrale Group), allowing the client to operate on Internet in stocks, bonds and derivatives quoted at the Borsa Italiana Spa, and also on Mta, Mot, Mif and Idem.

Also to remember is that recently the Sec Service Centre, electric calculating services for 16 Credit Societies, and Class Editori joined an agreement to offer on line trading services to the customers of the banks in service of Sec. The agreement will permit to the customers of the banks to operate via Internet directly at home or from the office to the Stock Exchange, accessing in real time historical data, analysis, graphs and news from the market.

Also Banca Fideuram aims on the Web, where it intends to make possible the availability of a series of information and consultancy services, besides the possibility to perform banking transactions, to transmit orders to the Stock Exchange (also on foreign quotes), to subscribe, live up and ransom shares of global funds. Fideuram intention is not to involve the *day traders*, but to give more instruments to its customers, belonging to medium high band and needing some qualified professionals assistance.

8. Conclusions

The Italian market hasn't assisted yet to the explosion of the on line trading phenomenon in the net and the bank is still the preferential channel used by the customer to perform their transactions in stocks.

In any case, Italian banks are becoming conscious of the tendency clearly defined in the US and are realizing the entity of these changes and the urgency to develop adequate strategies. The development of these systems constitutes for the Italian banks and brokers a really important opportunity in front of the growing integration between financial markets related also the Euro introduction.

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