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Mastering strategic renewal – lessons from the financial services sector

A new cross-border study suggests that some of Europe's most established financial institutions are failing to adapt to regulatory and technological change. Top management can choose from four clearly defined options.

How do large multi-unit firms in the financial services sector reconcile the conflicting forces of profits for today and flexibility to adapt for tomorrow?

Profits for today require order, control, and stability: adaptation for tomorrow requires flexibility and creativity in the quest to add value. In the European financial services industries these conflicting tendencies are increasingly obvious. Existing large financial players seem well placed to exploit the present but ill-suited to adapt to the future. Why is this so, and what can be done about it?

In 1998 the Erasmus Strategic Renewal Centre started an international research programme, funded by an Impuls research grant of the Board of the Erasmus University, Rotterdam and focused on the largest European firms as well as new entrants to the financial services sector. Six European business schools participated (beside Erasmus these were Bocconi of Milan, City University from London, HEC in Paris, Jönköping International Business School and the Norwegian School of Management), ensuring that the programme had a pan-European character. The project sought to answer if and how financial institutions change in the face of governmental and regulatory influences, as well as how they respond to changes in technology and consumer preferences.

European financial services – a changing landscape

The European financial services landscape is changing dramatically. Until the mid-1980s, the European financial services sector was characterised by significant governmental involvement and by numerous institutional and regulatory limitations on the domestic, cross-border, and cross-sector activities of financial service firms. The process of deregulation and harmonisation in the financial services sector has been a gradual one and has varied considerably across European countries.

Figure 1 (right), shows that the United Kingdom is the European leader when it comes to achieving regulatory change, closely followed by the Netherlands. The UK has used deregulation to promote competition in its financial services industry. Sweden, meanwhile, comes out best where speedy implementation of new technology is concerned (e.g. ATM networks, remote banking facilities, branchless banks), followed again by the Netherlands and the UK. France and Italy come last in the diffusion or spread of both regulatory and technological change. Sweden's relatively low position in diffusing regulatory changes can be explained by its late joining of the European Union.

Patterns of diffusion therefore vary from country to country. To detect changes in the rate of diffusion of regulatory and technological changes, we added up the time lags of the five countries for each indicator.

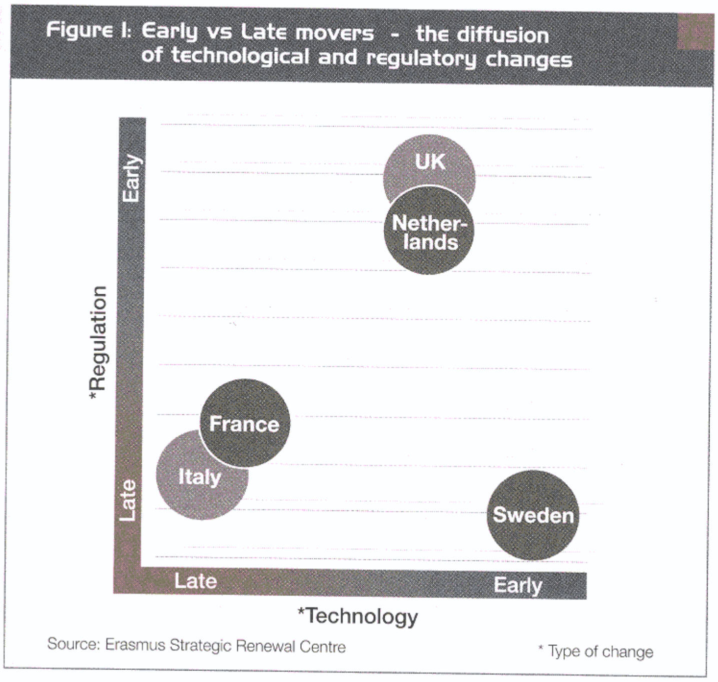
Figure 2a shows the increasing speed of diffusion of the regulatory measures. Whereas the time lag between the introduction and application of deregulated interest rates and liberalised capital flows amounted to up to eleven years for some countries at the beginning of the 1980s, the diffusion period for new prudential regulations was two years at the most in the middle of the nineties. The speed of diffusion not only increased by a factor of five but appeared to follow a more similar pattern across the countries investigated. The trend is less clear for the speed of diffusion of recent technological developments.

Figure 2b nevertheless suggests that the more recent the developments in technology, such as internet banking, the faster the adoption rate compared to older technologies, such as ATM networks. At the beginning of the 1970s the average time lag between first movers and followers regarding ATM networks was about twelve years. In the midst of the 1990s, the average time lag with respect to introducing internet banking was about two years. Based on the presented data, this suggests

Key messages

- The UK and the Netherlands are leading the European financial services sector in terms of responding to regulatory and technological changes – but late movers, France and Italy, are starting to catch up.
- Multi-unit firms can choose from four different pathways in their quest for strategic renewal. Each involves a different role for top and front line management.
- The four 'journeys' can be labelled Emergent, Directed, Facilitated, and Transformational.
- Rabobank Nederland is an example of an organisation that has sought to move from Directed to Transformational Renewal over the last decade; ING has tried to move from Emergent to Facilitated.

Figure 1: Early vs Late movers - the diffusion of technological and regulatory changes



Source: Erasmus Strategic Renewal Centre

* Type of change

the speed of diffusion of technological developments increased about six times. These preliminary results suggest a process of European convergence in which regulatory and technological changes are dispersed faster and faster across EU countries.

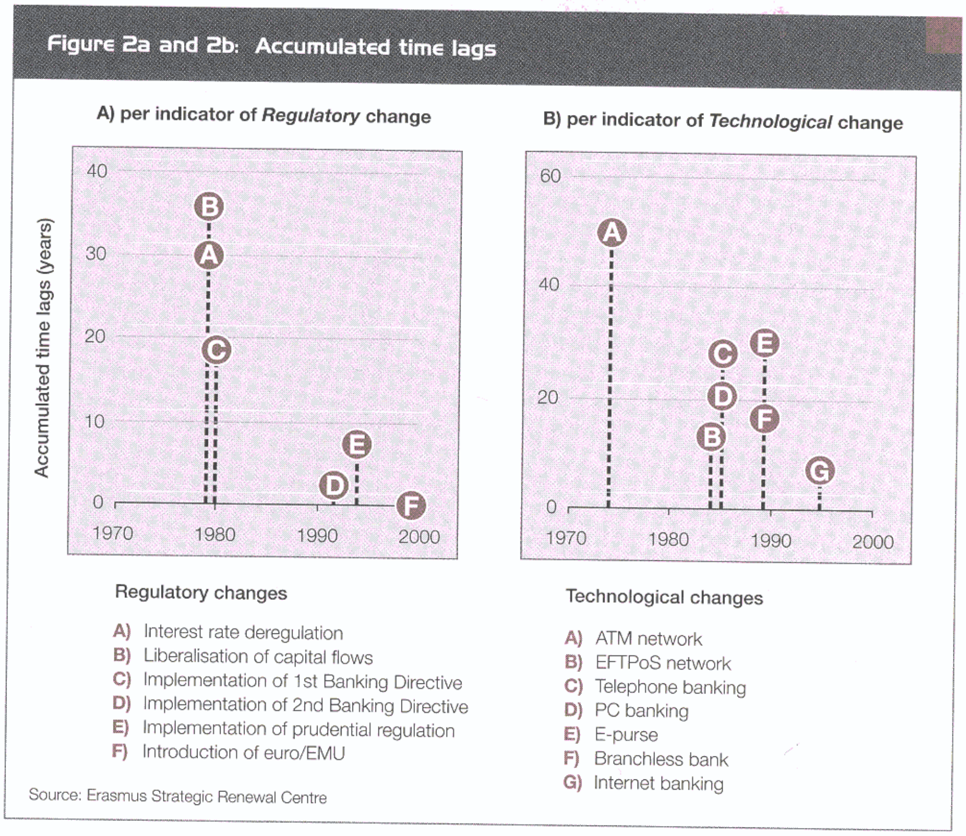
The European financial services sector, we believe, is likely to enter a new level of turbulence in the 21st century. The consolidation process of the past decade appears to have had a primarily domestic focus, aimed at gaining economies of scale and defending the home turf. Of the investigated countries, this process was most extreme in the Netherlands and Sweden, suggesting a new wave of both cross-border and cross-sector consolidation will take place in nearby markets and sectors. Novel technologies, new business models and strategic alliances may partly replace often difficult-to-manage mergers and acquisitions by making it easier to offer financial services around the clock to customers located anywhere. Information technology by itself, however, is no panacea, merely enabling a multi-channel banking strategy. As Klinkerman notes in 'The electronic stampede' (1996), electronic banking operating expenses are estimated at only 25 to 30 per cent of the cost of providing traditional banking services through brick and mortar branch offices.

These opportunities will also encourage non-financial players like GE and Microsoft, telecom companies such as KPN and Vodafone, and European retailers like Ahold, Sainsbury's and Tesco to step up their interest in the financial services sector. The confrontation between these non-financial players and the incumbents, each looking for strategic renewal options, will give rise to an even more dynamic and interdependent financial services landscape in which the boundaries will become less clear. We now begin to see the shape of an upcoming 'rugged landscape' that could shake up the sector's established players. The challenge for them will be both to compete and to co-operate with the newcomers, making strategic renewal a necessity for survival.

UK and Dutch financial institutions: herd behaviour

Given the first-mover behaviour in the UK and the Netherlands, how do leading Dutch and British financial services companies 'renew'? We define strategic renewal broadly as the activities these firms undertook to alter their path dependence in order to align their competencies with the new environment and increase their competitive advantage. In this connection, our empirical approach focused on developing and measuring new metrics to reveal insights into key attributes of strategic renewal, facilitating analysis and comparison of strategic renewal processes within and between firms over time and across different nations. As managers tend to better remember their successes than their failures, we have designed our metrics

Figure 2a and 2b: Accumulated time lags



Source: Erasmus Strategic Renewal Centre to capture a firm's realised actions rather than perceived actions, allowing us to study the actual behaviour of firms and preventing ex-post sense-making. Our metrics incorporate actions reported as confirmed in annual reports and the *Financial Times* over the period 1990-1997, to log only those actions known to have materialised rather than proposed actions and speculative reports. We employed various experts to check our classifications, data and findings, and applied NUD*IST software to analyse the data. In particular, we looked at three metrics of strategic renewal:

- The context metric of strategic renewal: internal versus external actions. This metric analyses the choices firms make regarding internal renewal versus external renewal through acquisitions. Actions were divided into new business ventures, closing offices, reorganising activities and new product launches (internal) versus merger, acquisitions, joint ventures and alliances (external).
- The content metric of strategic renewal: exploration versus exploitation-type actions. In a 1991 article 'Exploration and exploitation in organizational learning', J. March states that while exploitation is primarily related to refinement and improvement of the efficiency of existing activities, exploration is related to search and innovation activities. Exploration actions are therefore defined as renewal actions that add new activities to the current repertoire of the organisation, or that increase the geographic scope of the firm. Examples are internet banking, or a bank entering insurance. Exploitation actions are defined as renewal actions that elaborate on the current range of activities and fall within the current geographic scope, or that rationalise activities. These include cost savings, the dissolution of product ranges, sale of activities and increasing scale of merger or acquisition.
- The process metric of strategic renewal. To investigate the process of strategic renewal, we have investigated speed of renewal actions by counting the number of actions per time period.

Figure 3 (right), shows how the Dutch and UK companies are positioned according to two strategic renewal dimensions, the horizontal axis showing the average external/internal ratio over the eight-year research period, while the vertical axis depicts the average exploration/ exploitation ratio.

Herd behaviour at industry level: a shared passion for exploitation.

The first remarkable feature is that, of the eight firms investigated, seven firms show on average rather similar exploration/exploitation ratios, suggesting an industry-specific common mindset, at least regarding the content of strategic renewal. The results showed an apparent preference for leveraging routines and resources as opposed to changing routines and developing new resources and competencies. Such convergence within the financial services industry and across two countries is largely unexpected since our sample includes insurance companies and banks from different sectors of the financial services industry, with different regulatory environments and different skills, distinctive competences, historical investment policies, and entrenched structures.

Herd behaviour at country level: similar external/internal ratios within countries.

A second significant finding is that four of the five Dutch firms (i.e. ABN AMRO, Aegon, Fortis, and Rabobank) show a preference for using external over internal actions, while UK firms show the opposite predilection. The preference for external over internal actions among the Dutch companies is marked, with twice as many external actions to internal ones. In contrast, UK firms used twice as many internal actions as external ones. Although it is not surprising to find that firms differ in their use of internal versus external renewal actions, it is remarkable that discernible country effects contribute to the explanation of this phenomenon.

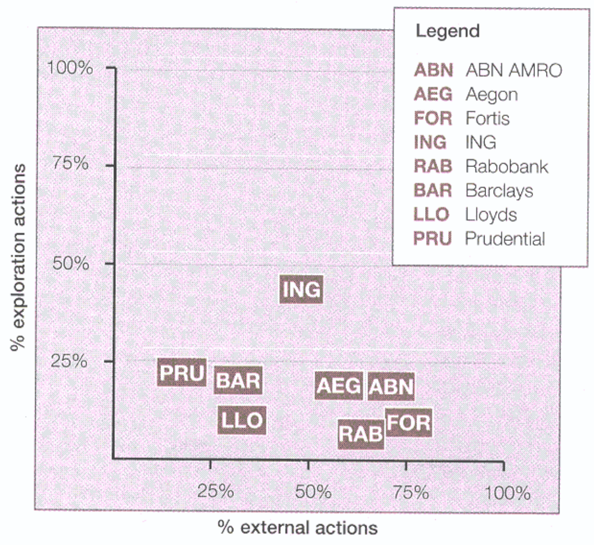
Managerial choice: Outlier behaviour, and differences regarding speed.

A notable exception in our sample of companies is ING. The firm has a significntly higher than average exploration/exploitation ratio. Moreover, the firms considered here differ markedly in terms of the speed of renewal. Among the Dutch firms, Aegon averaged about three renewal actions per year as compared to about ten renewal actions per year for ABN AMRO, while similar differences also appear among the UK firms: Barclays has an average of about 17 actions a year, while Prudential's average is about six. These differences were to some extent related to issues of financial awareness measured by the relative number of text units regarding financial statements in the Report of the board. In other words, more financial aware firms such as ABN AMRO and Barclays with a strong focus on shareholder value seem to undertake more renewal actions per time period.

Mobilising renewal journeys in well-established firms

These findings raise the important managerial question as to whether there is one best journey of renewal, or,

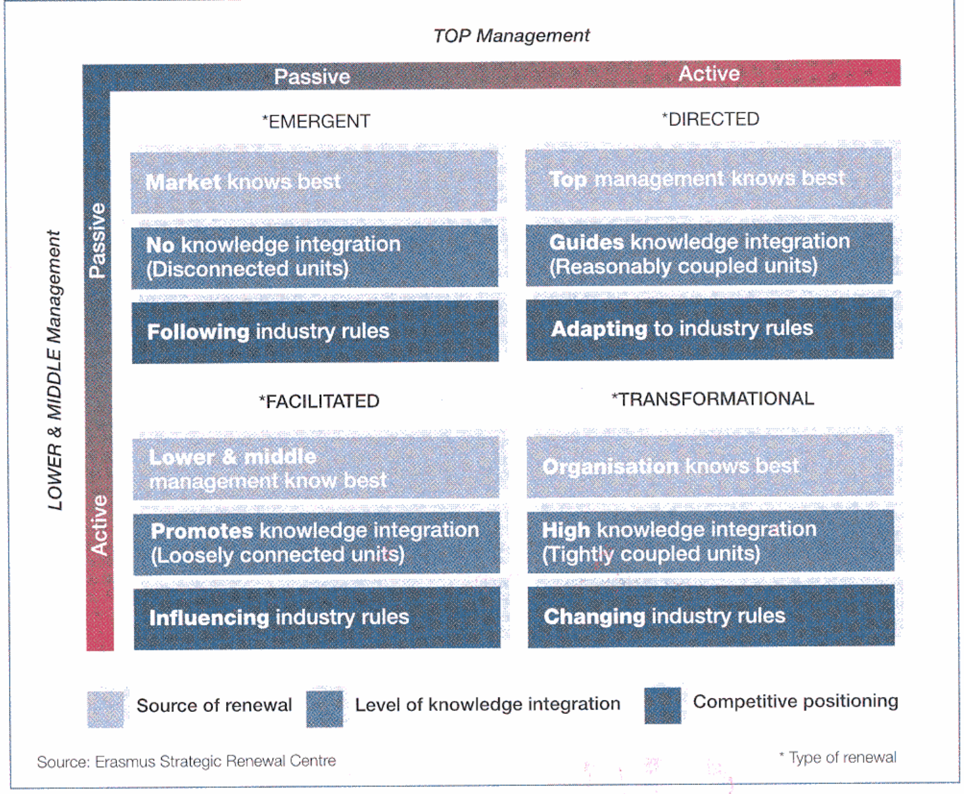
Figure 3: Exploratory activities vs External renewal



Source: Erasmus Strategic Renewal Centre alternatively, whether there are many journeys that reach the same goal. By combining several degrees of environmental selection and managerial adaptation, we distinguished four idealised journeys of renewal, which managers in multi-unit firms can use as a guide to their thinking (see Table 1): Emergent, Directed, Facilitated, and Transformational.

Two of these journeys, Emergent and Directed Renewal, are clearly associated with what many banks are doing today. They are both characterised by passive front and middle line management (see Table 1, right).

Table I: Idealised 'Renewal journeys' of financial firms



TOP Management

LOWER & MIDDLE Management

	Passive	Active
Passive	*EMERGENT Market knows best No knowledge integration (Disconnected units) Following industry rules	*DIRECTED Top management knows best Guides knowledge integration (Reasonably coupled units) Adapting to industry rules
Active	*FACILITATED Lower & middle management know best Promotes knowledge integration (Loosely connected units) Influencing industry rules	*TRANSFORMATIONAL Organisation knows best High knowledge integration (Tightly coupled units) Changing industry rules

▨ Source of renewal ▨ Level of knowledge integration ■ Competitive positioning

Source: Erasmus Strategic Renewal Centre

* Type of renewal

Emergent Renewal journeys: follow the market. This journey of renewal is rooted in the assumption that some managers believe that they should be essentially outwardly oriented or passive, their role being to amplify market forces and market signals for the benefit of the unit managers. For example, top managers set their business unit targets based on profits, rather than internal processes such as speed of new product development, and then typically reward their middle and unit managers with bonuses closely linked to these targets. We observe that ING bank in the early 1990s followed this approach.

The emergent journey has low administrative costs, and is common among many high-performing conglomerates in stable mature environments. Units often perform very well in the short-term, selecting carefully among their capabilities to maximise returns. Failure has clear sanctions: when a division or unit is 'selected-out', it is closed, sold, or denied resources. The emergent journey is usually defended in terms of its suitability for dealing with mature, slow moving environments, with little evidence of synergies between units that cannot be done through the market. The benefit of the emergent approach is that it avoids the myopia of being wedded to particular ideas or notions; a trap that mature firms can fall into in even mature environments. Historically, many financial service firms such as Barclays and ING have adopted this approach in stable industry conditions; it is doubtful if this journey is so suited to volatile environments where there is a need to build synergies.

Directed Renewal journeys: top management should be in control. In Directed Renewal journeys, top managers believe they have some power over their environment. In this perspective, renewal journeys are driven by *a priori* managerial intentions cascaded down through the organisation. A key role for top management is to provide the purpose or strategic intent in guiding journeys of renewal of multi-unit firms. As a result of top-down strategy making, multi-unit firms make their strategy changes deliberately, adapting to the competitive environment, with top management explicitly managing the balance of exploration and exploitation by bringing in new competencies to some units while utilising well-developed competencies in others.

Rabobank is an example of a business that took this journey during the first half of the 1990s. Top management in the Dutch-based co-operative bank group orchestrated organisational change processes that enabled knowledge-integration among loosely coupled units. Top management deliberately aimed to become a completely customer-driven organisation. The period of Lloyds/TSB under Sir Brian Pitman also bears a strong resemblance to the Directed Renewal ideal. His industry foresight resulted in Lloyds/TSB growing from the smallest of the UK clearing banks into one of the most successful and profitable financial players in the UK. His influence was so strong that Lloyds' managers were prone to make decisions on what they thought Pitman might think, rather than relying on their own judgement.

Directed Renewal typically results in interference in the way units are structured, and influences the way resources are allocated internally. Top management may have a preferred organisation design (such as the matrix) and a capital allocation rule (x% to new products, y% to improving processes). Top management typically argues that highly integrated firms need direction and hierarchy for regulation of internal change and that careful co-ordination is vital to avoid different units going off in different directions. The risk of 'paralysis by analysis' is always present, making this journey difficult in dynamic, rapidly changing environments. Directed Renewal appears to be particularly suited to firms experiencing steady growth or decline, where the benefits of hierarchy in terms of formal planning and control can be fully realised.

But what can organisations do in situations when following the market is not enough or top management is not in control? The other two journeys, Facilitated and Transformational Renewal, are a clearer representation of possible patterns for the future. They are much less common in mature environments and imply significant challenges to traditional management thinking. They require front-line and middle management to take a more active stand. They are more complex, co-evolutionary and subtle approaches to management.

Facilitated Renewal journeys: increase variety of renewal initiatives.

In the Facilitated Renewal journey lower levels of management are active in the choices for, and mechanics of, renewal. Top management's role is to create a strategic context for nurturing and selecting promising renewal projects by ensuring the maximum incentives for front-line initiative. The logic of this journey is that front-line managers have the most current knowledge and expertise and are closer to the routines and sources of information critical to innovative outcomes, and that top management can act as retrospective legitimiser or judge and arbiter in support of lower-level initiatives. In the Facilitated Renewal journey, profits targets and market share are no longer the sole objectives for measurement, being replaced by a more balanced internal-external perspective which takes into account actions such as the frequency of new product and service introductions and the operation of goals such as the share of revenues from new ideas. In addition, top management may intervene in guiding the structure of units, suggesting or directing forms of organising. As *Financial Times* journalist Christopher Brown-Humes pointed out at the time, the establishment in 1995 of Egg (the branchless Prudential bank) was organised in this way. The bank was built by the people who were going to run it. To ensure flexibility, planning was done step by step instead of following a masterplan. The co-involvement of the future managers and employees, and the project's 'no-blame' and forward-looking culture helped ensure its successful establishment.

By comparison with the emergent journey, firms are likely to show a more balanced portfolio in terms of exploitation units and exploration units and allow much more potential for learning across the firm's units. Yet the thinness of the top management group and the lack of significant resources devoted to moving knowledge can make intra-corporate learning more limited than in other journeys. While the facilitated journey is far more difficult for top management to handle, it has the potential to yield far greater results when the environment is turbulent and there is a need for cross unit co-ordination. However, top management's lack of direct control over the organisation makes it difficult for the multi-unit firm to engage in any large-scale developments that require central co-ordination or synergy across units. Facilitated Renewal is therefore appropriate in highly complex and dynamic markets where deliberate strategy of any kind becomes difficult.

Transformational Renewal journeys: mobilise a company-wide renewal process.

In the Transformational Renewal journey, top management still believes it can influence the environment, but also believes in working closely with the lower levels. Transformational Renewal journeys are associated with significant unlearning, new ways of thinking and new mindsets, different paths of technology, and particular kinds of corporate entrepreneurship. The corporate entrepreneurship literature suggests this journey is a holistic exercise that eventually involves the whole business: requiring systemic rather than piecemeal changes in the multi-unit firm. This change may cascade through the organisation, and it is quite clear that organisations can move in cycles between one extreme (exploitation) to the other (exploration), with periods of systemic exploration when the organisation is renewing and changing its skills and competencies. This renewal journey is therefore likely to be characterised by an imbalance between exploration and exploitation.

In Transformational Renewal the top management team is led by a chief executive who is much more than an administrator; he or she is a transformational leader who drives the process from the front but involves others and brings them along too. Transformational Renewal demands that the whole organisation must be involved if radical change encompassing new technologies and new processes is to be accomplished. For the multi-unit firm this journey is quite different from Directed Renewal. Besides transformational leadership, it emphasises the importance of middle management entrepreneurs connecting to different levels of the organisation. This is not the case of one level driving another, but of teamworking among levels and functions.

Can firms change journey?

For many financial services firms inertia prevents the renewal journey being altered in a fundamental manner. Although firms cannot make such transitions very often, we argue that it is indeed possible. For instance, the Rabobank Group, which celebrated its 100-year existence in 1998, followed a Directed Renewal journey in the first half of the 1990s. Top management aimed to orchestrate the integration of organisational knowledge. The organisational units were not very tightly connected. As the Rabobank Group grew in size due to acquisitions, such as that of the co-operative insurer Interpolis in 1990, it came to resemble a large centralised organisation. Organisational units began to complain that the corporate centre, Rabobank Nederland, was imposing its product-driven strategies upon organisational units such as the local banks. In the second half of the 1990s, Rabobank Group therefore tried to move towards Transformational Renewal. In 1996, the then CEO pointing out that "The hierarchical, pyramidal structure, with its tendency to uniformity, belongs to the past... Traditional organisation concepts start from concentration of knowledge at the top, to be directed downwards via the hierarchy. Owing to the distribution of knowledge it has become impossible and unnecessary to manage organisations from the top... Hence, it is better to think in terms of the network concept. The organisation as a system of relations between people, who collectively want to realise a shared idea."

> 'We now begin to see the shape of an upcoming 'rugged landscape' that could shake up the sector's established players. The challenge for them will be both to compete and to co-operate with the newcomers, making strategic renewal journeys a necessity for survival.'

This Transformational Renewal was further accelerated through a corporate-wide decision making process to revitalise the co-operative foundation of the Rabobank which resulted in a new 'ambition statement' and strategic orientation in 1999. According to Rabobank's 1999 Annual Report, a top priority was the creation of synergy between the organisational units, and a more decentralised management approach resulting in a reduction of the size of the corporate centre. Furthermore, it was decided that new name 'Rabobank Group' better captured the ambition of a network than the old 'Rabobank organization'.

ING has also altered its dominant renewal journey during the last decade, from merely Emergent towards Facilitated Renewal journeys. Thanks to large-scale merger and acquisition activity, ING had become by the beginning of the 1990s a collection of unconnected divisions (Postbank, ING Bank, Nationale Nederlanden) each subject to its own external market forces. ING's top management only stressed financial performance criteria and did not actively redesign its multiple divisions. During that period ING clearly followed the Emergent Renewal journey. However, during the second half of the last decade and in particular in 1999 and 2000, top management took a much more active role in creating an internal selection environment which reflected external market forces (quasi-selection), while managers of the organisational units were given more responsibility to stimulate knowledge integration among formerly loosely connected units. At present ING's renewal journey – exceptionally for most of the major European banks – is in transition from Emergent towards Facilitated Renewal.

Which journey for the future?

Is one of these idealised journeys more successful than the other journeys of renewal? The Emergent Renewal journey represents an extreme, where top management amplifies market pressures, often enforcing more rigorous standards than would otherwise be imposed. There is no doubt that for substantial periods of time, financial firms have done very well by adopting such emergent journeys. Directed Renewal appears to be particularly suited to firms experiencing steady growth or decline, where the benefits of hierarchy in terms of formal planning and control can be fully realised. However, in these emergent and directed journeys' firms can at best follow or adapt to industry rules.

In contrast, in Transformational Renewal where front-line managers are working most intensely with top managers, learning is intense and leads to exploration and renewal. Here, top management sees its role as inspiring new forms of behaviour; it may even change the rules of the industry. As a development model it sounds ideal, but there appear to be drawbacks. We suggest it is poor at dealing with technological discontinuities, while the journey may not be sustainable over time because of the supreme effort required for all the parties involved. The firm lurches from states of high exploration to high exploitation, placing severe demands on managerial capacity.

On the other hand, scholars specialising in complexity theory provide valuable evidence that Facilitated Renewal may be very effective, and could dominate the future landscape. Renewal proceeds most rapidly, they argue, when top management makes small adjustments to a familiar rhythm, recombining the portfolio of units so that novelty is deliberately generated without destroying the best elements of past experience. Top management operates on unit managers indirectly, taking advantage of the tendency for myriad local interactions to self-organise into a coherent pattern. Rather than shaping the pattern that constitutes strategic renewal (Directed Renewal), managers shape the context within which it emerges, speeding up co-evolutionary processes.

Broadening managerial choice

Our journeys point to important lessons for practising managers and those who teach them. By setting up the benchmark of 'selection' where managers are seen as passive actors driven by path dependency, we point out that there are real choices, both explicit and implicit. Each is distinctive from the others in that they have different benefits and costs, and may differ in efficacy according to environmental stimuli. As a result, each implies differences in roles for top and front-line management.

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