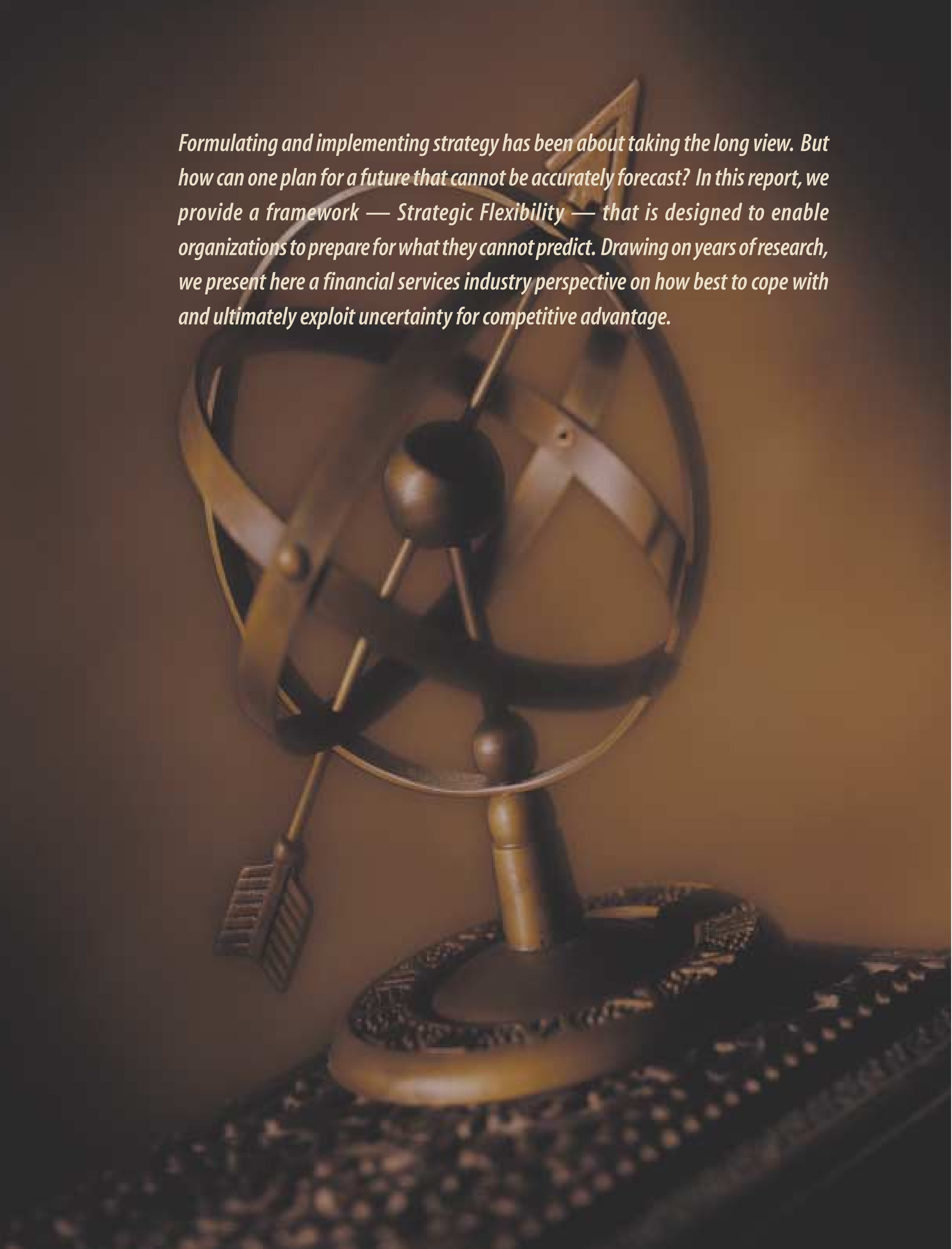
Deloitte Research

Strategic Flexibility in the FINANCIAL SERVICES INDUSTRY

Creating competitive advantage out of competitive turbulence

A financial services industry study by
Deloitte Consulting and Deloitte & Touche

Formulating and implementing strategy has been about taking the long view. But how can one plan for a future that cannot be accurately forecast? In this report, we provide a framework — Strategic Flexibility — that is designed to enable organizations to prepare for what they cannot predict. Drawing on years of research, we present here a financial services industry perspective on how best to cope with and ultimately exploit uncertainty for competitive advantage.



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Executive Summary

The complexity of the financial services industry can overwhelm any strategist. Companies in the financial services industry (FSI) must cope with multiple dimensions of change involving regulation, technology, globalization, new competitors and business models, capital market pressures, and constantly changing customer demands.

Worse, on all of these dimensions it is not merely their complexity that proves daunting, but the uncertainty surrounding them. How will regulatory policy change, and what will the implications of those changes be? What new technologies will emerge and how will they affect existing business models? How will the capital markets react to new strategic initiatives, and what will that reaction mean when it comes time to make the next acquisition?

Moreover, the uncertainty itself concerns two issues: *what* will happen, and *when* it will happen.

Existing tools for strategy formulation and implementation are of limited help because they are premised either on a relatively stable future or on the ability to make roughly accurate predictions of what the future will hold. For example, traditional industry analysis presupposes that the structure of an industry will remain stable long enough for meaningful action to be taken. However, when it can take only months for the industry to change significantly, pursuing a particular course of action – for example, an acquisition – that is geared to the needs of today's industry structure seems foolhardy.

Trustworthy predictions would help, but few strategists have demonstrated the ability to repeatedly and precisely foretell what lies over the horizon. Whether it is Thomas J. Watson Jr.'s well-known forecast of a world market for five computers or the more recent and (apparently) equally inaccurate bullishness of the capital markets regarding Internet stocks, there are far more examples of failed attempts at forecasting than successful ones. The French absurdist playwright Eugene Ionesco was right when he said, "one can only predict events after they have occurred."

Still, the uncertainty that plagues some of the most important questions facing the financial services industry does not relieve executives of the need to think strategically or to make decisions that will move their organizations forward. What FSI decision makers need is a new set of strategic planning and financial evaluation tools that are designed specifically to cope with uncertainty.

We present just such a set of tools in this report. Specifically, by drawing on years of research across a range of industry settings and competitive contexts, we have developed a powerful approach to strategy under uncertainty and organized it into a four-phase framework. *Strategic Flexibility* provides a rigorous yet adaptable methodology that will help you guide your organization through uncertain and turbulent waters.

The figure below illustrates the four phases of the Strategic Flexibility framework.

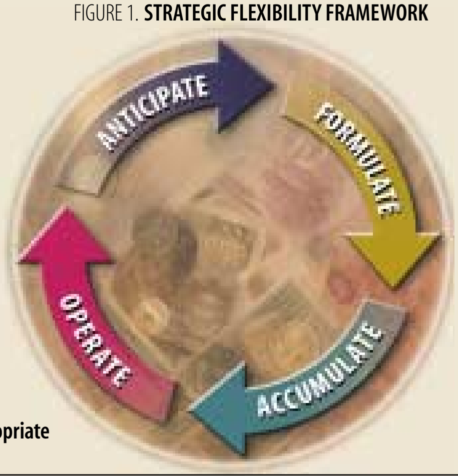
FIGURE 1. **STRATEGIC FLEXIBILITY FRAMEWORK**

ANTICIPATE

- **Identify drivers of change**
- **Define the range of possible futures**
- **Develop scenarios**

OPERATE

- **Execute the core strategy**
- **Monitor the environment**
- **Exercise or abandon options as appropriate**



FORMULATE

- **Develop an optimal strategy for each scenario**
- **Compare optimal strategies to define "core" and "contingent" elements**

ACCUMULATE

- **Acquire those capabilities needed to implement the core strategies**
- **Take options on capabilities needed for contingent strategies**

SOURCE: DELOITTE CONSULTING ANALYSIS

Consider each in turn:

ANTICIPATE

The uncertainty that shrouds tomorrow does not mean we should abandon all efforts to anticipate what lies ahead. Scenario-based planning provides a proven process by which executives can understand the drivers of change affecting their industry, their organization, and even the successful launch of specific products or services. By analyzing the dynamics of change and defining how key drivers might evolve and interact, executives can construct a workable number of discrete scenarios for their business. This scenario space defines the future worlds in which an organization is likely to find itself, and so provides a context for determining the nature and extent of the flexibility needed to compete effectively no matter how the future unfolds.

FORMULATE

Once the range of possibilities for the future has been defined, the challenge is to create a strategy that is optimized for each scenario. That is, the strategist asks, "If I knew the future were going to turn out like *this*, what would my best response be?" Answering this question is best done using the many tools available for industry and competitive analysis. Porter's five forces[i], Hamel and Prahalad's core competency[ii], Brandenburger's co-opetition[iii], and Christensen's disruptive technologies[iv] are only four of the many different approaches that have been developed to assist in formulating strategies appropriate to a given situation.

Analyzing the strategies developed for each scenario typically shows that, while certain initiatives are pertinent only to a single version of the future, others are appropriate for all or most of the scenarios. For example, international expansion might make sense only if particular circumstances materialize. Other kinds of investments – for example, in customer relationship management software – might be essential no matter what transpires. Those elements that are common to all scenarios constitute the core strategy for the organization – the no-regrets bets that an organization can begin implementing today. Elements that are unique to a given strategy make up the contingent strategies – those actions that make sense only if a certain state of affairs comes to pass.

ACCUMULATE

With a clear sense of what strategy the organization will pursue in each possible future world, and the core and contingent elements of those strategies identified, a firm can now begin to build or acquire the resources needed for each strategy. To implement the core strategy, the prescription is conceptually straightforward: press ahead with the development and deployment of the appropriate capabilities. This is by no means simple in its application, but similar to strategy formulation, there is at least an established body of management research and practice to call upon.

More challenging still is the need to secure access to those resources and capabilities that are needed on a contingent basis. For example, assume that for a particular FSI company expansion into China is a contingent strategy that depends on changes in the regulatory regime there, and establishing a distribution channel in China is an element of that contingent strategy. While there is no need to delay or hedge in obtaining resources needed for a core strategy, what a firm requires in the case of the Chinese expansion strategy is more tentative – the right, but not the obligation, to activate desirable distribution channels in that geographic market. The company would like to lock up the right partners without at this time committing the investment necessary to actually expand operations into China.

It is here that the emerging discipline of real options provides not only insight but also guidance. Drawing on years of proprietary research in this area, we have developed an approach to real options that provides new ways of thinking about the purpose of diversification and the valuation of investment opportunities. In our Chinese expansion example, a firm might take a real option on distribution partners in China through partial equity stakes and explicit long call options on the outstanding equity. Alternatively, outright acquisition might be necessary, but the incremental investment required to employ the new channel would be withheld. Either way, the cost of controlling the channel partner can be viewed as the cost of an option on eventually using that channel to expand into China. In other words, diversification – be it into new geographic markets or new product markets – creates option value on future integration opportunities.

From a valuation perspective, such initiatives rarely appear attractive when viewed through the lens of traditional net present value calculations. This is because a significant portion of the value of real options on assets associated with contingent strategies lies in the flexibility they create. Conventional discounted cash flow approaches at best underestimate this value, and typically ignore it altogether. Identifying the value of diversification motivated by the need for strategic flexibility therefore requires a fundamental shift in the way in which investment opportunities are conceptualized and their value quantified. We provide suggested approaches for properly taking into account the value created by strategic flexibility.

OPERATE

The first three phases of the Strategic Flexibility framework constitute a new approach to strategy formulation and portfolio structure. Our research shows that these are necessary but not sufficient conditions for success; another crucial component is a new approach to the management of a multibusiness organization. When an organization must face the future not with a clearly articulated and precise battle plan, but instead with a series of contingent strategies and just-in-case resources, the key to implementation success is knowing when and if to exercise the real options that created the necessary flexibility. This requires a very different role for the corporate office than the one typically prescribed, one in which senior executives take an active role in determining the timing and mechanisms of integration among otherwise autonomous operating units, rather than simply defining overall goals and delegating the task of implementation.

It is not merely in the exercise of options that the corporate office must get its hands dirty. In an uncertain world, it is inevitable that some options will have to be abandoned. Unfortunately, it is a fact of organizational life that walking away from projects is not easily done. Operating managers become psychologically invested in specific projects, convinced that given more time and resources their particular initiative can be made to work. More importantly, good management has come to be defined as delivering projects on time and on budget, and so terminating a project because the option it represented never came into the money can be seen as a failure on the part of the managers involved. Of course, it is not failure at all, but simply a recognition of the fact that the circumstances under which a given strategy, and hence a given project, was optimal never materialized. Balancing the need for commitment in implementation by operating managers with the inevitability of having to abandon some undertakings without undermining the careers of those involved requires a new kind of involvement in decision making from corporate executives.

This report explains why this approach to strategy is needed in today's financial services industry, and provides examples of how the four phases have been applied by some FSI leaders. It is our hope that this report will serve as a catalyst for using Strategic Flexibility to chart a course for your organization through the industry's turbulent waters.

[i] Porter, M. E. (1980). Competitive Strategy. New York, Free Press.

[ii] Prahalad, C. K. and G. Hamel (1990). "The Core Competence of the Corporation." Harvard Business Review (May-June): 79-91.

[iii] Brandenburger, A. M. and B. J. Nalebuff (1996). Co-opetition. New York, Doubleday.

[iv] Christensen, C. M. (1997). The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail. Boston, Harvard Business School Press.

Uncertainty in the Financial Services Industry

The financial services industry is undergoing a metamorphosis: market boundaries and competitors, once clearly labeled, are being transformed by a wide array of forces for change. Incumbents are invading each other's customer and product markets even as start-ups and established firms in seemingly unrelated industries threaten similar incursions. Many aspects of the industry's transformation remain unclear, and tremendous uncertainty surrounds even the most basic questions of strategy:

- **What products and services should I offer?**
- **Who are my customers?**
- **Which new entrants are a flash in the pan, and which are truly dangerous?**
- **Who are my competitors?**
- **Which components of my business model are worth retaining?**
- **What business am I really in?**

… and, despite it all, industry executives are increasingly forced to make bet-the-company decisions with no guarantees of success.

In the face of this turbulence and unpredictability, the strategic challenge facing financial services companies is no longer one of predicting the future, or even attempting to create it, but rather one of coping with and exploiting inescapable uncertainty. Doing this, however, requires a fundamentally new approach to strategy formulation and implementation, for the traditional tools of strategic planning and financial analysis are simply not up the task. In their stead is proposed a framework for thinking about strategy amid uncertainty called *Strategic Flexibility*, an approach that has been under development for several years (see *The Genesis of the Strategic Flexibility Framework*).

At the same time, flexibility is only necessary, and hence valuable, when two conditions are met. First, significant uncertainty must impinge on the major strategic issues facing an organization or an industry. When strategists have confidence in their projections or predictions of the future, there is no need to be flexible. Second, there must be no clear best response to this uncertainty: even if the future is unpredictable, if there is one all-purpose riposte flexibility is of no use.

If Strategic Flexibility is to be valuable to executives leading financial services organizations, one must first assess the degree to which the financial services industry is subject to both an unpredictable future and debate regarding how best to respond.

The Horsemen of Uncertainty

There are many drivers of change that serve to make the future of the financial services industry unclear – everything from customers and globalization to capital market pressures and general economic conditions. Indeed, the horsemen of uncertainty are so numerous they might better characterized as a cavalry. To illustrate how these drivers create the kind of uncertainty that makes flexibility valuable, consider two in detail: regulation and technology.

REGULATION Most financial services executives view many aspects of regulation as an impediment to the success of the industry. Barriers between markets and restrictions on product offerings stifle innovation and growth. However, the consequences of changes in regulation can be highly unpredictable. For example, in the 1980s the U.S. government deregulated deposit interest rates and increased deposit insurance. This resulted in fierce competition for consumer accounts, resulting in a dramatic fall in the net interest spread on funds. Consequently, many thrifts found themselves with too thin a cushion to absorb losses from real estate loans, which contributed at least in part to the savings and loan crisis.

The genesis of the STRATEGIC FLEXIBILITY FRAMEWORK

Like financial services, the communications industry is characterized by big-money bets in the face of tremendous technology, market, and regulatory uncertainty. An examination of how some of the world's leading communications companies have come to cope with and exploit this uncertainty yielded the foundations of the Strategic Flexibility framework presented in this report.[i]

To determine the defining characteristics of strategically flexible organizations, we compared the management practices of diversified firms coping with high levels of uncertainty with those of similarly diversified firms competing in comparatively stable industries.

The primary insight of that work was that diversification strategies can create much-needed strategic flexibility if they are implemented appropriately. In the communications industry, this meant diversifying into new lines of business that were seen as potentially – but not necessarily – critical elements of future product market strategies.

For example, BCE, a US$20 billion Canadian communications firm, has operating units in local, long distance, and wireless telephony, satellite television, television broadcasting, newspaper publishing, Internet portals, and Internet access – to name only the consumer side of its activities. BCE acquired these assets over a 15-year period, and has for the most part run them as autonomous business units. However, as technology and markets have matured, the firm has begun to explore significant convergence product offerings. For example, in early 2001, the firm launched an effort to develop and deploy the ComboBox: a set-top box designed to integrate the Internet, satellite television, computers, and TVs with new types of interactive media content and commerce opportunities.

The diversity of BCE's operating divisions created strategic flexibility by affording the company real options on convergence-driven product and service offerings. By acquiring the requisite operating assets early in the game, BCE was able to lock up needed access. By operating these divisions as independent units, it was able to delay its integration efforts until favorable outcomes were more likely. Each new operating division, then, represented the right, but not the obligation, to make further investments in cross-divisional cooperation and integration.

A distinguishing characteristic of this kind of flexibility-driven diversification – one that we see in the diversification initiatives of many financial services companies – is that a portfolio of operating units will have a particular structure: there will tend to be a cluster of fairly tightly integrated operating divisions (or related divisions), as well as a number of otherwise quite independent divisions (or unrelated divisions). Combining diversification strategies in this way is something that earlier research had suggested should be avoided.[ii] However, in industries characterized by high degrees of uncertainty, these combination, or hybrid, diversification strategies are actually associated with superior capital market returns.[iii] This suggests that investors are not blind to the value that flexibility-driven diversification can create.

[i] To obtain a copy of the report entitled "Strategic Flexibility in the Communications Industry: Coping with uncertainty in a world of billion-dollar bets", register at www.dc.com/research and download a free copy. Alternatively, contact the study's author, Michael Raynor, at mraynor@dc.com.

[ii] Each type of diversification (related, unrelated, or vertical) is seen to require a specific set of administrative systems to be managed effectively. These administrative arrangements are thought to be fundamentally incompatible – that is, a firm cannot have in place both systems appropriate to a related diversification strategy and systems appropriate to an unrelated diversification strategy. Consequently, combining diversification strategies means that some part of the diversified firm's portfolio will be subject to an administrative mismatch, and will therefore suffer a performance penalty. See Hoskisson, R. E. and M. A. Hitt (1994). "Downscoping: How to Tame the Diversified Firm". New York, Oxford University Press.

[iii] Raynor, M. E. (2000). Hidden in Plain Sight: Hybrid Diversification, Economic Performance, and "Real Options" in Corporate Strategy. "Winning Strategies in a Deconstructing World". R. Bresser, D. Heuskel, M. Hitt and R. Nixon. London, John Wiley & Sons: Chapter 4.

On a smaller scale, the 1994 Riegel-Neal Act unlocked the gates to interstate banking, unleashing a wave of acquisitions as American banks raced to create what the rest of the world has long enjoyed: a truly national banking system. Despite the vigor with which many banks have pursued this strategy, the results of many of these mergers have been profoundly disappointing. In some cases, a drive for national scale has served to reverse a long run of steadily increasing shareholder returns.[1]

Recent changes in the U.S. regulatory environment have yet to play out completely, and the major players are developing a variety of responses, suggesting that the end game has yet to come into focus. In 1999, with the passage of the Gramm-Leach-Bliley Act, financial holding companies could house banking, securities, and insurance products under one roof. In response, some financial services companies have begun to build scope through titanic cross-industry mergers, such as those uniting Chase Manhattan and J.P. Morgan, Citicorp and Travelers/Salomon, and Bank America and Montgomery Securities. At the same time, some marquee names in investment banking, such as Merrill Lynch and Goldman Sachs, remain independent. The only safe conclusion is that the best way to respond to the changing relationship between investment banking and the other pillars of the financial services industry remains unclear.

The prospect of regulatory change has increased the uncertainty surrounding the financial services industry in Europe, as well. Beginning in the late 1990s, the European Commission (EC) began developing and promulgating its Financial Services Action Plan (FSAP). Consisting of 41 directives that cover everything from rules on digital money and harmonizing pensions between nations to the creation of a single European securities exchange, the FSAP could well reshape Europe's financial services industry.

The impact of these regulatory changes is unclear, as is the timing of their implementation. To meet the 2005 target date for implementation, the EC, the Council of Ministers, and the European Parliament will have to move far more quickly than they did when harmonizing rules for corporate takeovers – a far less ambitious set of regulatory changes than that envisioned for FSAP, yet one that remains unresolved after more than 12 years of debate.

TECHNOLOGY The impact of technology on the financial services industry has been significant. For example, it is clear that Web-based distribution has become a permanent element of banks' distribution channels. In the United States, for example, there are approximately 22 million online banking customers. Bank of America Corporation, with two million online customers, has the single largest installed base. If anything, online banks are even more popular in Europe, with an estimated with 28 million online customers.[2]

The Internet's impact has been even more significant in the American brokerage business. Consumers have moved online en masse to buy and sell stocks as online trading has slashed consumers' trading costs by up to 50 percent.[3] The reduced price and increased convenience seems to have generated enormous volumes for the successful service providers. For example, online trading at Schwab, the leading online stockbroker, has grown from nothing a decade ago to more than 80 percent of all of its trades today.[4]

Uncertainty remains manifest, however, for these changes say little about what precisely will happen next. In brokerage, for example, did the Internet simply amplify the proclivity of Americans for trading equities? If so, then one might expect online trading to have little effect on the brokerage business elsewhere. Or did the Internet create an entirely new segment of stockholders who will spring up in other geographic regions as the technology and the services diffuse? Beyond brokerage, online mortgages have not taken off even in the U.S. despite significant efforts by incumbents and start-ups alike. Indeed, some argue that online brokerages were as much a creature of the U.S. Internet stock bubble as they were the advantages of Internet-based trading per se, and as the NASDAQ returns to earth, the prospects for online trading – and by implication, perhaps online banking generally – will similarly fade.

IMPLICATIONS Deregulation and technology have combined to make the boundaries of the financial services industry increasingly permeable. Technology companies such as Microsoft and Intuit were among the first to act on the insight that the Internet could serve as a channel through which to provide financial services to consumers. Sony, too, is seeking to enter the Japanese financial services market through private label offerings of various financial products, including credit cards and leasing. Extending its brand even further into financial services, it recently launched an Internet bank, Sony Bank, in partnership with J.P. Morgan Chase and Sumitomo Mitsui Banking Corp. Microsoft, Intuit, Sony: Each has sought to leverage its core technology expertise and strong consumer brand to move into various segments of the financial services industry.

In Europe, telecommunications companies, particularly wireless carriers, are threatening to siphon off retail banking customers through wireless technology that lets consumers pay stores, restaurants, gas stations, and other retailers through a wireless device. How much of a challenge the financial services industry faces from this quarter remains unclear. However, with unparalleled reach and consumer mind share, the telcos pose a threat – or an opportunity – that deserves to be taken very seriously indeed.

Finally, online start-ups such as Auto-by-Tel and Realtor.com have added to their mixes specific financial products such as car loans and mortgages, respectively, that are complementary to their basic offering. In other words, in the course of mounting an Internet-based disruption of other industries, they are now competing against financial services incumbents. How successful will these firms be in the long run and how broad an impact will they have? If the rise of focused credit card and mortgage companies is any indication, it is unwise to dismiss them out of hand.

Responding to Uncertainty

Regulatory and technological change – only two of the many horsemen of uncertainty – are threatening to reshape the financial services industry in ways that are difficult to foresee. What is so challenging about these forces is that they do not all point in one direction or suggest a clear set of strategic priorities. Who is the biggest threat to established financial services companies: Sony in consumer finance, Vodafone in payments, Microsoft in both of these markets, or a focused, Internet-based start-up taking aim at an existing core product? What is the appropriate response: geographic scale, product scope, or leading-edge technology? What is the best way to compete: acquire, partner, or grow internally? And which much-anticipated upheavals will turn out to be false alarms, generating expensive countermoves that turn out to be unnecessary?

Of course, frameworks exist to assist in thinking through each of these problems. As a result, it is easy to fall prey to the belief that enough analysis and enough data will yield the right answer. This approach to strategy is built on the idea that it is possible to predict the future. The problem is that guessing even slightly wrong about the future can have severe consequences – at a time when the likelihood of being spectacularly wrong is higher than ever.[5]

To see why there is no best answer to the challenges facing financial services companies, consider the wide range of responses firms have developed to two critical challenges facing the industry today: strategic scope and the evolution of the payments system.

A TALE OF TWO STRATEGIES In the United States, a number of products lines have come increasingly to be dominated by divisions of diversified financial services companies, a trend that belies the received wisdom concerning the power of focus. As shown in Table 1, in credit cards, mortgage origination, equity underwriting, and insurance industries, monoline firms, or firms that derive the majority of their revenue from a single line of business are not as prominent among the largest players as they were 10 or even five years ago. Nevertheless, with the exception of credit cards, monoline firms remain a significant presense.

TABLE 1: **PRODUCT DIVERSITY VS. PERFORMANCE**
RELATIVE STANDINGS BY INDUSTRY SEGMENT: 1990 VS. 2000

LEGEND DIVERSIFIED MONOLINE

	PRODUCT CATEGORY[i]									
	CREDIT CARDS[ii] RECEIVABLES (US$MILLIONS)		MORTGAGES[iii] RESIDENTIAL ORIGINATIONS (US$ MILLIONS)		UNDERWRITING[iv] DEBT + EQUITY OFFERINGS (US$ MILLIONS)		PROPERTY & CASUALTY INSURANCE[v] NET PREMIUMS WRITTEN (US$ '000S)		LIFE & HEALTH INSURANCE[vi] NET PREMIUMS WRITTEN (US$ '000S)	
RANK	**1990**	**2000**	**1995**	**2000**	**1990**	**2000**	**1990**	**2000**	**1995**	**2000**
1	Citicorp ($28,000)	Citicorp ($73,300)	Countrywide Credit Industries ($34,584)	Chase Manhattan Mortgage ($76,559)	Merrill Lynch ($55,680)	Merrill Lynch ($290,286)	State Farm Group ($24,458)	State Farm Group ($33,294)	Prudential ($20,513)	Metropolitan Life ($30,572)
2	Chase Manhattan Bank ($9,266)	Bank One ($69,356)	Norwest Mortgage ($33,858)	Wells Fargo Home Mortgage ($66,907)	Goldman Sachs ($39,003)	Salomon Smith Barney/ Citigroup ($251,754)	Allstate Insurance Group ($21,623)	Allstate Insurance Group ($20,841)	Metropolitan Life ($19,972)	ING Group ($23,999)
3	Greenwood Trust Co. (Discover card) ($8,500)	MBNA America ($65,170)	Fleet Mortgage Group ($15,941)	Countrywide Credit Industries ($61,694)	First Boston ($32,267)	Credit Suisse First Boston ($212,343)	American International Group ($7,388)	Zurich/Farmers Insurance Group ($16,754)	Connecticut General Life ($12,737)	American International Group ($23,497)
4	Bank of America ($6,537)	Morgan Stanley Dean Witter ($37,975)	Prudential Home Mortgage ($15,651)	Bank of America Mortgage ($51,819)	Salomon Brothers ($32,232)	JP Morgan Chase ($207,242)	Aetna Life & Casualty Group ($7,350)	American International Group ($12,249)	Prudential Mutual Life ($11,779)	AEGON USA ($23,044)
5	First Chicago ($6,536)	Chase Manhattan ($33,572)	GMAC Mortgage ($14,063)	Washington Mutual ($47,299)	Morgan Stanley ($31,207)	Morgan Stanley Dean Witter ($194,952)	Farmers Insurance Group ($6,514)	Berkshire Hathaway Insurance Group ($10,404)	New York Life ($9,519)	Hartford Life ($18,555)

[i] Legend categories: Companies were classified as "monoline" if their primary business was in the product category being ranked, and if their ultimate parent companies did not operate significant businesses in non-related categories, both within and without the financial services sector. Otherwise, companies were classified as "diversified".

[ii] Source – "Card Industry Directory: The Blue Book of the Credit and Debit Card Industry in the United States", 1991 and 2001 editions, Faulkner & Gray

[iii] Source – "National Mortgage News: Top Residential Mortgage Originators", *1995 and 2000 rankings,* April 1996 and March 2001 editions, American Banker

[iv] Source – "U.S. Debt & Equity Offerings: Full Credit to Book Runner, 8 January 2001" and "All Domestic Issues: Full Credit to Lead Manager, 8 January 1996", Investment Dealers' Digest

[v] Source – "Best's Review Magazine", August 2001; "Best's Aggregates & Averages", 1991

[vi] Source – "Best's Review Magazine", August 2001; "Best's Review Magazine", July 1996 (NB: 1995 data used here as 1990 source was unavailable.)

The strategic challenge for the newly dominant diversified players is to exploit synergies among their various businesses. Focused players must ensure that sticking to their knitting remains a competitive strategy as the landscape shifts. This is especially true as scope-based competitors continue to expand their empires into the insurance business where focused firms maintain a significant presence. The most notable example of a scope-based player attacking the insurance industry is Citibank's acquisition of Traveler's, the fifteenth largest player in the life insurance and P&C fields: the explicit strategy here is to leverage Traveler's new access to Citicorp's distribution channels and new opportunities for bundling to move up the ranks.

Two companies illustrate in high relief the viability of both focus and scope strategies: Bank of New York (BONY) and Citigroup, respectively. Each has been very aggressive in building its franchise, both ranking among the most active acquirers in financial services, albeit in pursuit of their very different strategies (see *M&A Strategies in the Financial Services Industry*). Furthermore, each has outperformed its peer group.[6] Consider each in turn.

Bank of New York has always been involved in trust activities and securities processing dating back to 1787, when it processed the new U.S. government's first loan of $200,000. Despite these deep roots, BONY only recently entered the global custody arena. Prior to the mid-1980s, it used Mitsubishi Bank of California as a private labeler for its customers with international portfolios. During the initial years of its entry into the global custody business, its $100 billion in international custody assets barely placed it the top 10 global custodians in the U.S. In assets, it was dwarfed by Chase Manhattan, Citicorp, JP Morgan, and State Street.

In 1992, the bank's leadership embarked on a new strategy focused on securities servicing. Pursuing this course required stringent cost controls, an efficient securities processing capability, and, perhaps most challenging of all, shedding businesses that in 1995 generated over 25 percent of earnings. The result, however, was a company well positioned to compete more effectively for global custody accounts.

Even as it disposed of its noncustodial businesses, BONY sought to build scale by acquiring the securities processing businesses of nearly a dozen other banks that were exiting the custody field, including JP Morgan and Bank of America. By the end of the decade, BONY had vaulted into the top spot globally with over $3 trillion in custody – almost double the $1.9 trillion of its closest competitor, State Street Bank and Trust.

Today, Bank of New York is still pursuing its focused strategy and increasing its share of the global custody or securities servicing business through acquisitions. Assets under administration have grown to approximately $7 trillion, and securities processing revenue is expected to exceed 40 percent of total revenues by 2003. Fiduciary and securities servicing activities are expected to represent about 57 percent of earnings in 2001, compared to 27 percent in 1995 and 20 percent in 1994.

At the other end of the spectrum, Citigroup was created in 1998 through the merger of Citicorp and Travelers Group. The $70 billion transaction aligned the second largest bank in the U.S. with the brokerage (Salomon Smith Barney) and insurance giant and created a financial services company offering an unparalleled range of products and services. Coupled with this unmatched product scope, the new behemoth boasts 140 million customers in 102 countries, giving it the most extensive geographic reach in financial services history. The size and complexity of Citigroup is such that ex co-CEO John Reed remarked that "Citigroup is right at the edge of how big things can be managed."[7]

Despite the challenges, the company still expects to continue growing by acquisition and has held steady on a course dedicated to product and geographic scope. CEO Sandy Weill seems to believe that Citigroup will succeed only by competing in all sectors of financial services. The model Citigroup is building rests on three pillars: distribution channels, an unparalleled global footprint, and an unmatched breadth of products and services to create cross-selling opportunities.

M&A Strategies in the FINANCIAL SERVICES INDUSTRY

A merger and acquisition strategy can be analyzed along two dimensions: the total number of deals a firm does and the average size of those deals. Those firms ranked in the top 20 most active acquirers in the financial services industry between 1997 and 2000 are defined here as the population of firms for which acquisitions form an important part of their growth strategy. Within this group, the average deal had a value of US$13.9 billion, and the average firm did 34 deals. These two dimensions, each divided at the average value, suggest four generic M&A strategies. Each strategy is exemplified by a firm in each of these quadrants, and three data items are given for each representative firm: (1) Acquisitions – the number of deals done; (2) Average size – the average nominal dollar value of all acquisitions done; (3) Diversity – the number of different industries in which the target companies operated at the time of acquisition.[i]

In the lower left quadrant, we have the *Opportunists* – firms for which M&A plays an important role in growth, but generally on a deal-by-deal basis. Regions Financial Corp., for example, has been growing largely within its own industry, but has done so using a comparatively small number of small deals. When the right opportunity presents itself, the company is not shy to act, but has not, relatively speaking, been particularly aggressive in seeking out acquisition targets.

In the upper left quadrant are the *Snipers*. As illustrated by JP Morgan Chase's activities, these firms pursue relatively few, but relatively large, deals with an eye to filling out a specific element of their portfolio. With few, but large, deals that have tended to be clear complements to existing lines of business, the Snipers have very specific targets and they acquire them with unwavering determination.

In the lower right quadrant are the *Consolidators*, firms that roll up comparatively fragmented industries by executing a large number of relatively small deals concentrated within a small number of industries to achieve scale in a specific sector. Bank of New York provides a sterling example of how this strategy can be successful as it has rapidly reached scale in the global custody business.

Finally, in the upper right quadrant are the *Synergy Seekers*, firms that execute a large number of large deals, with an associated diversity of acquisition targets. Citigroup illustrates this approach well. The firm has done a large number of large deals across a broad range of industries, all premised on the notion that the resulting bundle of services will allow the firm to create an unassailable competitive advantage.

[i] For present purposes, industries are defined by two-digit SIC codes, and the industry of a firm is defined by the primary SIC code for each company, as given in the company's SEC filings.

GENERIC MERGER AND ACQUISITION STRATEGIES

AVERAGE $ VALUE OF TOTAL DEALS PER FIRM: $13.9B	Low	High
High	**JP Morgan Chase** • Acquisitions: 22 • Average size: $6.0B • Diversity: 8 industry targets *SNIPERS*	**Citigroup** • Acquisitions: 38 • Average size: $2.2B • Diversity: 14 industry targets *SYNERGY SEEKERS*
Low	**Regions Financial Corp.** • Acquisitions: 22 • Average size $233M • Diversity: 8 industry targets *OPPORTUNISTS*	**Bank of New York** • Acquisitions: 41 • Average size: $260.4M • Diversity: 6 industry targets *CONSOLIDATORS*

AVERAGE OF TOTAL NUMBER OF DEALS PER FIRM: 34

SOURCE: MERGERSTAT; DELOITTE CONSULTING ANALYSIS

What these two extremes illustrate in sharp relief is that neither focus nor scope is the best approach in today's financial services industry; each can work. No dominant strategy has emerged, and so the optimal portfolio-level response to the competitive pressures shaping the industry remains largely uncertain. Instead, what we see are different companies pursuing very different strategies that are explicitly or implicitly based upon conflicting theses regarding the future of financial services.

THE PAYMENTS SYSTEM The European scene is particularly instructive when considering the uncertain future of the payments system, particularly as various levels of government attempt to harmonize the patchwork of markets that characterize the European Union. The broad range of factors affecting European payments can be grouped into three clusters: new rules and regulation, blindingly quick technological change, and the emergence of new players.

First, for the last five decades, the rules governing the finance arena have remained largely unchanged. However, at the national and pan-European levels, significant change appears imminent.

Nationally, as the result of a wave of concern about the level of competition among banks, governments have been drafting legislation to reshape the rules surrounding payments systems. For instance, in the United Kingdom, the Cruickshank report concluded that banks have a monopoly on payment networks and this was working to the detriment of consumers. In France, the authorities have recently placed price controls on the cost of processing checks.

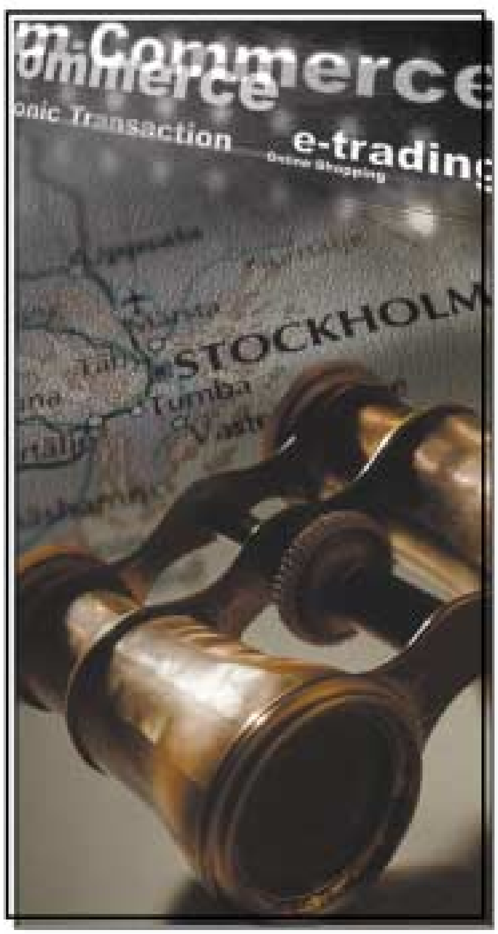
At the pan-European level, the EC and European Central Bank are driving for the creation of a single payments area. However, there are still significant differences between each of the Euro 11: the average cost of a cross-border credit transfer in the Euro-zone ranges between €8.91 (payment originating from Luxembourg) and €29.68 (payment originating from Portugal).

Simultaneously, the rapid adoption of new banking rules currently being debated within Europe, along with the introduction of the Euro, could create the world's largest financial services market. Yet, many players are ill prepared for this particular scenario and the opportunities it could unleash, betting instead on a protracted regulatory policy development process.

Second, the strategic issues associated with information and communications technology involve key unknowns for banks. Having spent vast sums over the last three decades building a sophisticated payment networks on an incremental basis, banks now face potential competition from other data network owners as regulators redraft the rules. The challengers to banks fall into two categories. One is the data network and management providers, such as EDS. These companies are looking at the opportunities to use their existing networks in new ways. The other consists of companies exploiting the digitization of cash together with the growth of mobile devices. For instance, Vodafone recently stated that "M-commerce will emerge as an important application based on the convenience that it offers to the user." Some experts believe m-commerce will be based at first on an m-wallet – an electronic environment to contain established credit and debit payments methods. It would then evolve into a micro-payments mechanism as an alternative to cash.[8] These two technology-related challenges could add up to a fundamental shift in how payments are made in both the B2C and B2B arenas.

Third, banks face competition from a rash of new entrants from a variety of sectors and geographic regions. In the past, regulatory walls separated banks and protected their activities. As these walls crumble, new players are seeking out new opportunities in financial markets. The range of new entrants is vast and includes mobile operators, data and IT giants, and even dotcoms such as PayPal. It could well be that none of these new rivals pose a significant threat to incumbent financial institutions – they may change the rules of the game, but take little in the way of market share, or they may run into difficulty due to any number of other problems. Nevertheless, these companies are deft competitors with a keen sense for both markets and technology, and so they cannot be ignored.

The challenge for European banks is constantly to sift the potential implications of these many developments in the payments arena. Different organizations are pursuing different tacks: some have done little, choosing only to monitor the situation. Others, such as ABM-Amro in Holland, have entered the fray only to reverse course as conditions proved less favorable than expected. Specifically, ABM's agreement with KPN, the Dutch telecommunications incumbent, has been abrogated. And still a third camp has gone live with m-commerce agreements, as exemplified by the Barclays-Vodafone joint effort in the United Kingdom. Therefore, as with the scale versus scope debate in the United States, strategy development in Europe is complicated because the timing and nature of the change these forces will effect remains unpredictable.



The Strategic Flexibility Framework

Along any number of dimensions of change, it is difficult to say what the future will hold. Indeed, not even change itself is guaranteed, for the future could be many things, including very similar to the present. Worse still, current levels of strategic ambiguity may not be a temporary phenomenon, leading one to conclude that it is not change that is the only constant, but unpredictability. The horsemen of uncertainty may well continue to alter – or merely threaten to alter – the structure of the financial services industry for the foreseeable future.

At the same time, there is no one best response to this uncertainty, no all-purpose strategy that will allow any firm to march boldly forward with no regard for the shifting sands around it. Whether coping with regulatory changes or technological innovations, deciding on the appropriate scope of the firm, developing a payments strategy, or any number of other critical issues, financial services firms have no sure-fire response on which they can call to guarantee their success.

Consequently, the two conditions that make flexibility valuable – uncertainty and the absence of an appropriate response to that uncertainty – characterize today's financial services industry. To help financial services executives create the flexibility they need, we propose the Strategic Flexibility framework, a radically different approach to strategy formulation and implementation.

A new approach is needed because the uncertain and potentially dynamic nature of the financial services industry undermines the applicability of more conventional strategic and financial planning tools. Frameworks such as Michael Porter's "five forces" are based on determining a company's overall market position using concepts such as existing competitors, barriers to entry, bargaining power of suppliers and customers, and threat of new entrants.[9] When the shape of an industry threatens to change rapidly, plans premised on any given assessment of the balance between these forces will likely be obsolete before they can be put into place. Managers would need a new analysis of their industry before the first iteration is complete.

The previous section of this report made the case that significant uncertainty plagues corporate strategy in financial services, and so top management needs a way to be competitive today while building the capabilities they believe might be necessary in the future. It is not enough, however, to be able to compete in one specific future; high levels of uncertainty mandate that companies build the capabilities needed to compete across a range of possible futures.

To cope with the challenges of fighting today's battles while simultaneously girding for a wide range of conflicts tomorrow, we have borrowed from the fields of scenario-based planning and real options theory. In combination with our own research on the management of diversified firms, the result is a robust framework that provides structure for thinking about uncertainty and how best to cope with a broad range of possible strategic threats without stretching a firm's resources too thinly. The four-phase Strategic Flexibility framework is summarized in Figure 1.

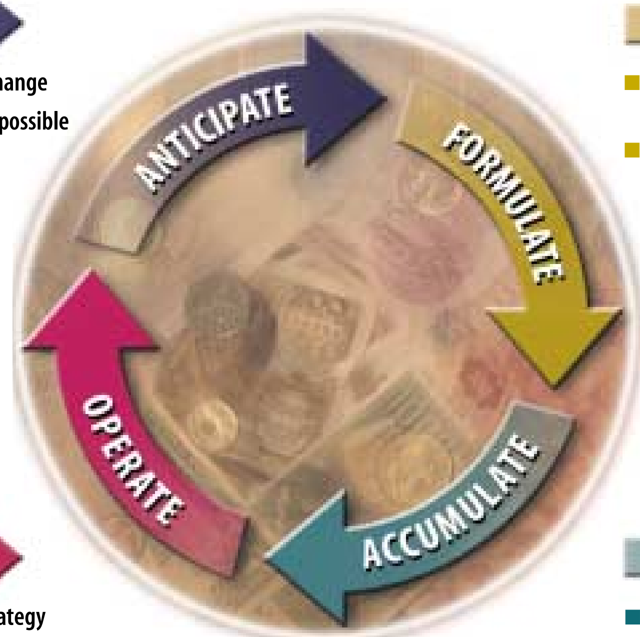
FIGURE 1. **STRATEGIC FLEXIBILITY FRAMEWORK**

ANTICIPATE

- Identify drivers of change
- Define the range of possible futures
- Develop scenarios

FORMULATE

- Develop an optimal strategy for each scenario
- Compare optimal strategies to define "core" and "contingent" elements



OPERATE

- Execute the core strategy
- Monitor the environment
- Exercise or abandon options as appropriate

ACCUMULATE

- Acquire those capabilities needed to implement the core strategies
- Take options on capabilities needed for contingent strategies

SOURCE: DELOITTE CONSULTING ANALYSIS

Consider each in turn:

ANTICIPATE

When making the case for the inherent uncertainty of the future of the financial services industry, it is important not to overstate the case and conclude that anything is possible. As ever, truth lies somewhere between extremes, and so although very little is certain, very little is totally uncertain, either.

Limning the boundaries of the possible is made tractable through scenario-based planning. As a tool in the strategist's kit, it has become increasingly popular. It is implemented in a variety of different ways, but we have found the following approach particularly useful.[10]

Scenario-based planning begins with an identification of the drivers of change that shape an industry's or a firm's future. In the financial services environment, for example, various regulatory initiatives by different levels of government figure prominently. Many other sources of change also need to be considered, such as political shifts, competitive threats, new technologies, and changes in the lifestyles and needs of critical customer segments.

Each of these broad categories embraces a range of issues. For example, a bank's corporate customers could be affected by still other factors such as trade blocs, evolving business structures, the vitality of emerging markets, and even the dispersion or centralization of regulatory authority. Some or all of the same forces (e.g., technology, regulation, globalization) will also shape retail markets, but in different ways. Telecommuting, increased or decreased leisure time, and the personal use of new technologies are only some of the manifestations of these same drivers of change.

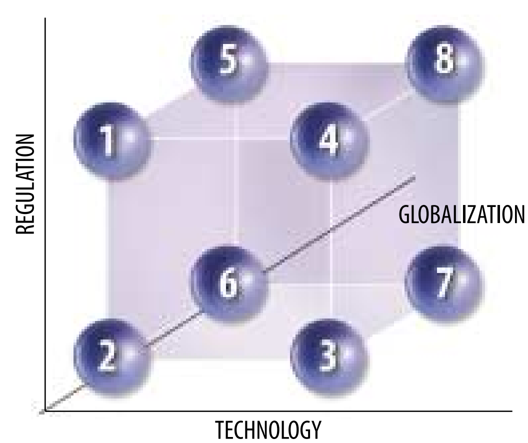
The range of possible outcomes for the each driver, or dimension of change, can be visualized as a straight line radiating out from the status quo, or point of origin, in a multidimensional space (see Figure 2). The limits of what is possible along each dimension define the edges of the boundaries of what tomorrow is likely to hold. Each corner of this space is a particular scenario – not a prediction of a particular future, but a limiting case of what is possible.

In theory, even this reductionist approach to uncertainty can be overwhelming. As shown in Figure 2, in a simple world with only three drivers of change, it is possible to have eight scenarios: one for each vertex of the cube. However, drivers of change are not independent of each other. It is unlikely, for example, that new communications technologies will reach full flower in a world where global markets are highly regulated and characterized by trade barriers. The relationships between drivers of change typically allow far more than three dimensions to be captured by as few as three to five scenarios.

Note that in this kind of scenario-based planning scenarios are definitely not predictions of the future. If they were, all we would have done is respond to uncertainty by replacing one prediction with several. Rather, each scenario serves as a sort of conceptual boundary marker that, together with the other scenarios, defines the space within which the future will likely fall (see *Scenarios for the Financial Services Industry*).

This kind of scenario-based planning serves to bound uncertainty at the level of the macro environment in a way that enables purposeful action, but without pinning an organization's hopes on predicting what fundamentally cannot be predicted.

FIGURE 2. **THE DIMENSIONS OF CHANGE AND THE BOUNDARIES OF UNCERTAINTY**



In the mid-1990s, Deloitte Consulting developed a set of five scenarios for the U.S. banking industry. Each scenario described a future world in terms of the key events that define it. Two of them are described in detail and the remaining three are summarized. Each illustrates both the range of change drivers that can go into developing a scenario and how the interactions among drivers of change make each scenario unique. A concluding section comments on how these scenarios have stood the test of time.

COST DRIVEN

Government takes a piecemeal approach to regulatory policy for the financial services industry, promulgating a poorly coordinated series of deregulation initiatives. As a result, banks are unable to pursue meaningful growth in new markets or realize any value from diversification initiatives.

Simultaneously, faced with increasing global unrest, defense budgets begin to swell again, resulting in slowly rising U.S. debt levels. As the federal government issues more bonds to fund the defense buildup, interest rates begin to rise, crowding out private investment, slowing economic growth, and strengthening the U.S. dollar. As domestic growth slows and wages begin to decline, the reduced spending power results in heightened consumer price sensitivity that drives demand for low-cost goods. This leads to increased imports from lower-cost newly industrializing countries.

With declining sales in their core businesses, a wide variety of nonfinancial services companies exploit the pock-marked regulatory landscape to move into slices of the banking industry. For example, discount retailers such as Wal-Mart and Home Depot open kiosks and begin accepting deposits, form buying clubs among their customers, and create innovative ways to finance purchases and process payments that circumvent the established order.

Overall, in a cost-driven world, banks face cost pressures, an anemic domestic economy, and a raft of new and powerful competitors, while lacking opportunities to leverage their existing capabilities in other sectors of the financial services industry due to confused regulation.

FREE MARKET TRIUMPHS

The ripple effects of technology advances, coupled with a broad, well-managed approach to deregulation, open up a wide range of new opportunities for banks. The freedom to enter new lines of business and new geographies is married with the technology-driven capability to create and service a broad variety of bundled products tailored to ever more tightly defined customer segments. A widely-deployed broadband communications infrastructure creates new distribution channels for reaching high-value, well-informed, but time-impoverished segments of society.

In commercial markets, more and more industries fragment and basic inputs from electricity to bandwidth are commoditized, leading to a host of new market-making opportunities for banks. Robust domestic economic growth, reinforced by recovery in Japan and higher growth rates in Europe, keep established non-FS players focused on their core businesses, giving banks the opportunity to leverage their existing strengths to reinvent the payments system and create electronic marketplaces on their own or in combination with technology partners.

As these trends take hold, product market differentiation between financial services competitors is diminished and brand becomes more important. Issues of transaction security and customer information privacy become paramount as more facts about consumers' lives are disclosed through electronic channels and single points of contact. Although nonfinancial companies tend to steer clear of the industry, new entrants remain a constant threat because technology reduces the minimum efficient scale of operations and customer choice is increasingly driven by perceptions of reliability, responsiveness, and innovation.

OTHER SCENARIOS

The three other worlds identified were:

Sustained Malaise: A full-scale, prolonged war in the Middle East (or a similar single catastrophic event) results in massive increases in oil prices. The resulting recession is escalated into a global depression through mis-guided protectionist trade policies that not only halt liberalizing trends, but also roll back the gains of NAFTA, the EC, and the WTO.

Cutthroat: Massive and rapid deregulation results in enormous confusion and knee-jerk price-based competition by existing players. As a result, consumers become cynical about the value of institutional loyalty and shift en masse to bank-hopping, constantly looking for the best deal. Initially bullish markets turn volatile as companies with maverick business models seek to exploit the uncertain implications of a newly deregulated environment, resulting in alternating spells of investor enthusiasm and disillusionment.

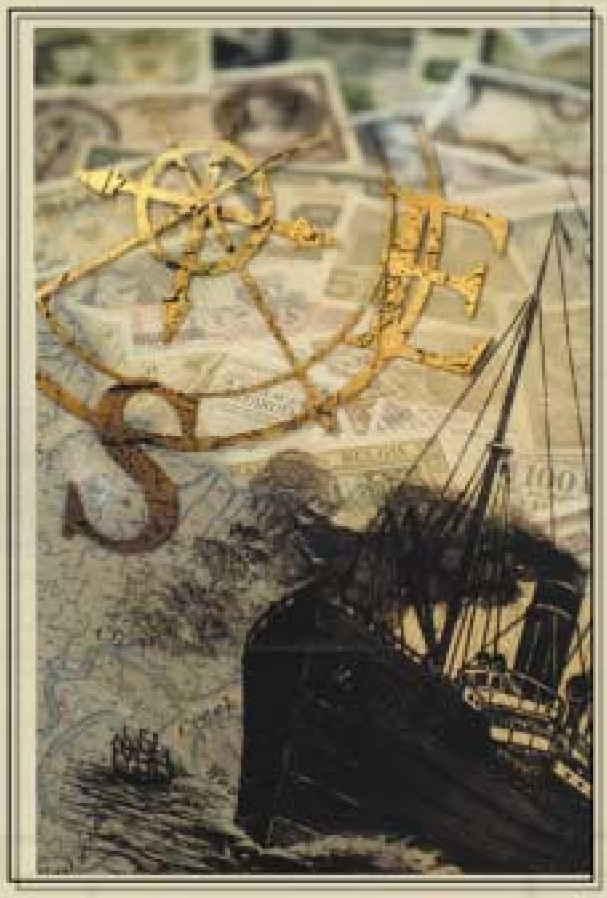
USA Inc.: Bolstered by technology-driven gains in productivity, the United States becomes the fastest-growing economy in the world. The resulting high growth permits selective tax increases, and the resulting budget surpluses are translated into investment in education, transportation infrastructure, and health care. Government policy succeeds in creating consortia in electronics, telecommunications, and biotechnology. Regional trading blocs, such as NAFTA, are expanded only to the extent they serve the interests of U.S. companies. U.S. global dominance becomes manifest in its solo effort to launch a manned mission to Mars.

CONCLUDING REMARKS

These scenarios were not intended to be predictions of the future. Rather, they served as a way to challenge assumptions about the future and to recognize that a wide variety of events – all entirely plausible – could well produce radically different future outcomes.

What we have seen since these scenarios were developed is a world that began down the *Free Market Triumphs* path, with overtones of *USA Inc.*, but that has now begun to resemble more closely *Cost Driven* with elements of *Cutthroat*. For the firms with the necessary flexibility, the turbulence of the last decade has been, if not smooth sailing, at least far less disruptive than it otherwise would have been.

Finally, what the passage of time reveals is the importance of renewing one's scenario-based planning. As with strategy itself, it is not enough to do it once and for all. Consequently, Deloitte Consulting has begun to develop a new set of scenarios for the financial services industry of the next decade.



FORMULATE

The next step is to determine the strategic implications of each scenario developed in the *Anticipate* stage. It is here that many of the more traditional tools of strategy formulation are entirely appropriate, since for the purposes of formulating a strategy for a given scenario, that scenario can be taken as a prediction. In other words, rather than apply the principles of conventional strategic planning at the level of a point prediction of the future, they are applied at the level of the scenario. In effect, in the *Formulate* stage, the strategist asks, "If we knew the future were going to turn out like *this*, what would be my organization's optimal response, and what would my organization have to do today to effect that response?" Porter's five forces, Prahalad and Hamel's core competency framework, and game theory, among others, can all be brought to bear in the service of identifying the best response to each possible world.[11]

A strategy merge serves to compare the strategies appropriate for each scenario. Those strategic elements that constitute a part of at least one scenario and that are appropriate (or at least benign) in every scenario constitute the core strategy for the organization – the no-regret bets that an organization can pursue, confident that whichever scenario ultimately materializes, these actions will form part of an optimal response.

Strategic elements appropriate in only some circumstances are contingent – actions that will be taken only if it becomes clear that a given set of circumstances is materializing.

For example, as discussed above, one scenario for the future has wireless network operators revolutionizing the payments system in Europe. In response, a raft of joint ventures and partial investments between telecoms and financial services companies were announced in 2000. Some have interpreted these initial forays as a precursor to the inevitable merging of segments of the telecoms and financial services industries.[12] But with so many of these initial deals now either mothballed or abandoned, this putative convergence seems far from certain. We suggest instead that these tentative moves are efforts on the part of the companies involved to secure for themselves elements of contingent strategies appropriate to one of several versions of the future of the payments system.

Out of the *Formulate* stage, then, a company emerges with a robust core strategy, and set of contingent strategies captured in a series of if-then statements that define how the organization can best respond to the unique requirements of a given set of future conditions.

ACCUMULATE

It is a reasonably straightforward step for an organization to take those actions associated with the core strategy: pursue those acquisitions and develop those capabilities that will serve it well no matter how the future unfolds. Valuing and integrating the needed components is operationally difficult, but conceptually fully consistent with established successful management practice.[13]

The second half of the *Accumulate* phase takes the form of acquiring those resources or capabilities required by contingent strategy elements. Unlike the core strategy, however, accumulating the ingredients of contingent strategies requires a very different approach for thinking about portfolio planning and financial evaluation.

Conventional strategic planning tools cope with uncertainty essentially by ignoring it. Consequently, in the face of a scenario-based approach to anticipating the future, a simplistic approach would be to attempt to cover every contingency by acquiring and integrating everything required by every strategy implied by the full range of scenarios.

Such a response is impractical for three reasons. First, the shopping spree implied by this reaction is almost certainly beyond the means of all but the two or three largest financial services firms in the world. Second, such an investment strategy would almost certainly destroy value, since it would result in enormous financial investments and organizational disruptions, the majority of which one would expect not to need. Third, the scenarios that bound the future of the financial services industry are sufficiently diverse that preparing for all of them in equal measure simultaneously would be impossible. For example, if one contingent strategy calls for product market diversification and aggressive bundling, while another requires strong focus and niche marketing, actively pursuing both strategies means being both focused and diversified at the same time.

What financial services companies need is a leveraged mechanism that hedges the *strategic risk* associated with *not* pursuing the strategy required by a given scenario.[14] And, just as financial risk can be hedged using financial options, this kind of strategic risk can be hedged using *real options*. In taking a real options approach to accumulating those resources or capabilities that might be needed, financial services companies acquire the right, but not the obligation, to control and integrate specific operating assets into their core businesses when and as appropriate. Just as a financial option costs only a fraction of the value of the stock on which the option contract is written, a real option can cost only a very small percentage of the full value of controlling and integrating the resources required by a scenario that, today, is only a possibility.

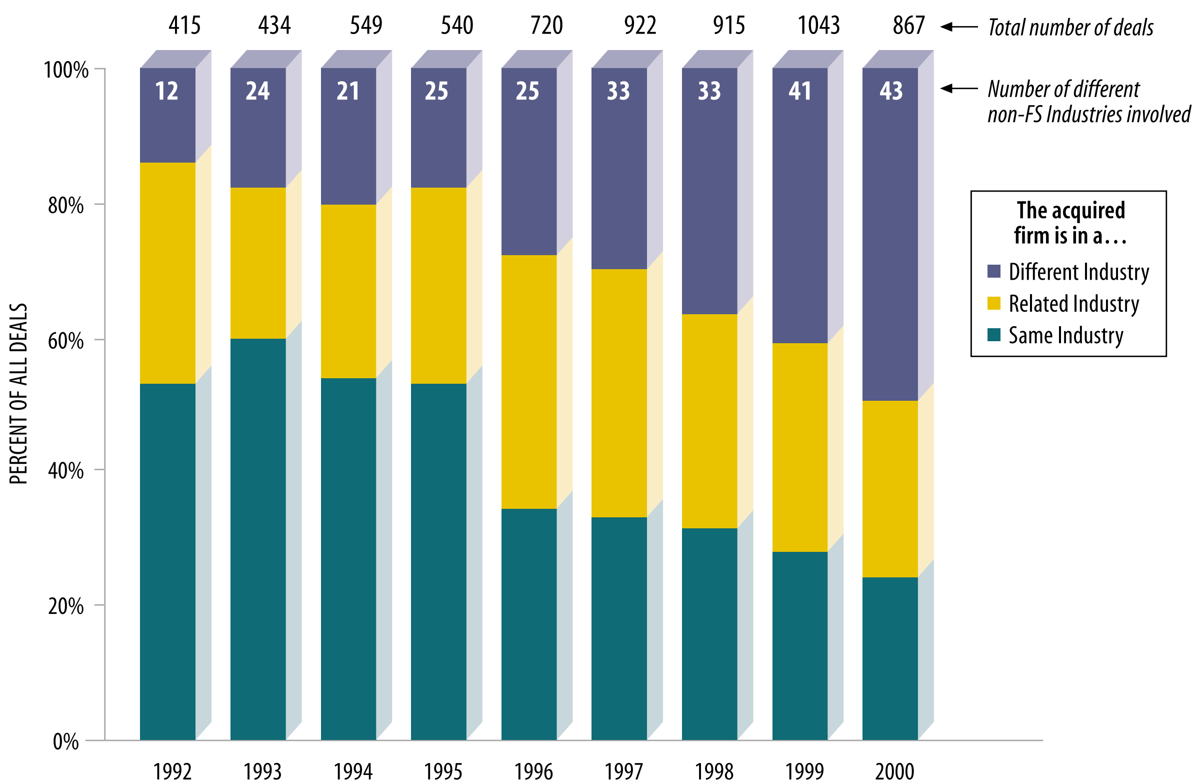
For example, Citigroup's portfolio of companies is unparalleled. But the purpose and utility of many of these acquisitions is still being assessed and understood, even by Citigroup itself. In his 2000 letter to shareholders, CEO Sandy Weill described Citigroup as a "work in progress," an organization defined by the *opportunities* it has created for cross-selling, for interdivisional synergy, and for international expansion.

What we see in these portfolio moves is the acquisition of a large number of real options on the strategy associated with a scenario where scope and synergy across a broad range of product markets is especially powerful. The price of these options was whatever premium Citigroup paid for each acquisition. The exercise price of each option is the cost associated with overcoming the complex challenges of integrating a given acquisition and exploiting the relevant synergies. Each option is viable as long as the conditions under which a given asset would be valuable remain possible, and the benefits of integration outweigh the costs of maintaining an asset within the company.

An analysis of the merger, acquisition, and joint venture activity between 1992 and 2000 suggests that a broad cross-section of the industry is adopting Citigroup's strategy, albeit typically on a smaller scale. As shown in Figure 3, since 1992 there has been a steady trend among financial services companies to pursue opportunities outside the traditional financial services space: the share of total M&A deals in which a financial services company acquired a firm in the same or related industry has fallen from 78 percent in 1992 to 45 percent in 2000. Tellingly, the total scope of economic activity involved in these deals involving unrelated targets has grown tremendously as well. In 1992, for example, mergers between financial services and nonfinancial players covered only 12 different industry sectors; by 2000, such deals involved companies from 43 different industry sectors. A similar phenomenon is evident the structure of joint ventures involving FSI companies: over the same eight-year period, the mean relatedness of the parties to joint ventures involving at least one traditionally-defined financial services player has fallen almost 40 percent (see Figure 4). We see in these trends evidence of accumulating options on the resources needed in the event that the financial services industry is reshaped along competitive boundaries very different from those that define it today.

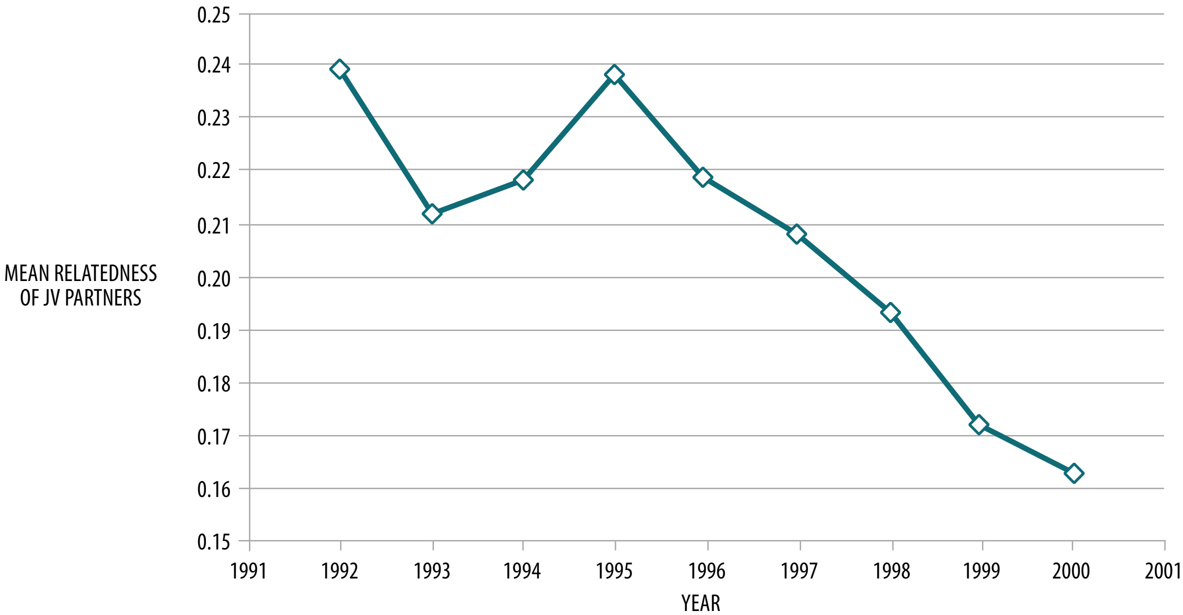
Unlike financial options, which have clearly defined expiry dates, real options can remain viable for decades. For example, AIG opened an office in Beijing in 1980, yet had to wait until 1992 to receive a full insurance license. The multiyear investment in a sub-scale office that had limited commercial freedoms was essentially an option on making further investments in a timely fashion as China has gradually liberalized. The result is that today AIG has the lion's share of the $16 billion in premium income written by foreign insurers in China.

FIGURE 3. **THE INCREASING DIVERSITY OF ACQUISITION TARGETS**



SOURCE: MERGERSTAT.
The financial services industry is defined here as those companies with a primary SIC code between 6000 and 6499 inclusive. A target company is in the same industry as the acquirer when the two companies have the same three-digit or four-digit SIC code. Related industries have the same two-digit SIC code. Different industries have only the first digit or no digits of their SIC in common.

FIGURE 4. **THE INCREASING DIVERSITY OF JOINT VENTURE PARTNERS**



SOURCE: SECURITIES DATA CORP.
The relatedness measure is a percentage of the maximum possible overlap in SIC codes between parties to a joint venture agreement. For example, if all the parties to a joint venture had the same four-digit SIC code, the relatedness measure would be 1. As the parties to a joint venture have fewer and fewer digits in common, the relatedness of the parties to the joint venture falls.

No matter the vehicle for acquiring a real option – partnership, joint venture, partial equity stake or acquisition – the valuation issue is never far from the surface.[15] Each option must be acquired, sometimes at considerable expense, and if a company remains committed to creating shareholder wealth, the value of the flexibility created by a given option must always exceed the price paid. Traditional discounted cash flow techniques such as NPV are poorly suited to this task. Thankfully, tools exist that can identify the value of real options, thereby making the *Accumulate* phase subject to the same rigorous analysis as the *Anticipate* and *Formulate* stages (see *Valuing Flexibility*).

OPERATE

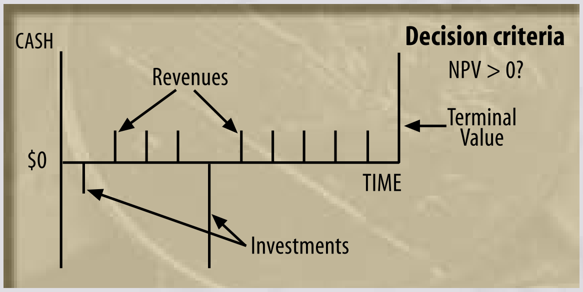
With the resources required for the core strategy in place and the appropriate options taken on those resources required by contingent strategies, the final stage is to *Operate* this resource complement to maximum advantage.

For the core strategy, this means tackling the conceptually straightforward but operationally demanding task of implementation. For the contingent strategy elements, something far different is required. Specifically, an organization must monitor the competitive environment in order to determine which aspects of the various scenarios identified in the *Anticipate* phase are actually beginning to materialize and which appear to be waning as possibilities – thereby resolving some uncertainty and reducing the scenario space for which a company must prepare. This, in turn, will determine which of the real options taken on the resources required by the relevant contingent strategy are in the money and should be exercised.

Valuing FLEXIBILITY

Discounted cash flow (DCF) valuation techniques, such as net present value (NPV) analysis, are well-understood and widely-used tools for comparing investment opportunities. Using these tools requires predicting the cash flows associated with a given project and then discounting the associated cash flows into present day currency using an appropriate risk-adjusted rate. For example, building a new manufacturing plant might have negative cash flows in early periods as a result of the costs of building the plant, followed by positive cash flows as a result of selling the plant's production. A terminal value is ascribed to the project at the limit of one's confidence in the cash flow projections. If the discounted cash flows have a value of $0 or more, then the project is said to clear its hurdle rate, and is a profitable investment. This approach can be illustrated as follows:

A TRADITIONAL NVP PROJECTION



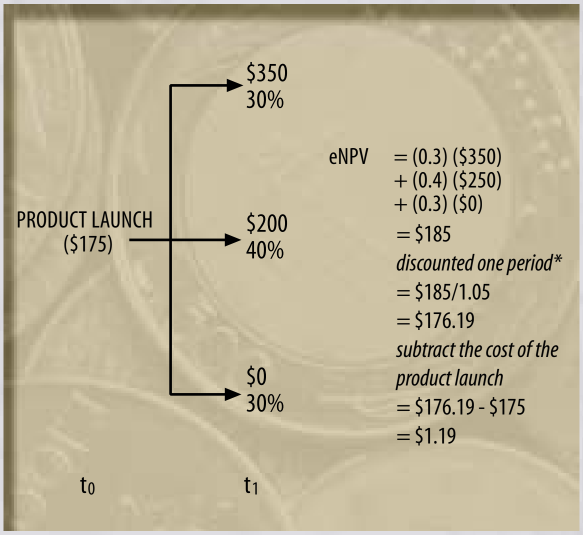
Highly uncertain investment environments reveal the many weaknesses of this approach. For example, a common practice is to increase the discount rate applied to highly uncertain cash flows, thereby reducing their value. However, uncertainty raises the possibility of pleasant surprises as well as downside risk. Consequently, arbitrarily increasing the discount rate serves only to penalize uncertainty when in fact, as with financial options, higher levels of uncertainty surrounding an investment's outcome might actually make that investment more attractive.

To try and cope with this fact, more sophisticated NPV approaches include the use of expected NPV (eNPV). Most often, this takes the form of estimating a high, medium, and low outcome to a project. Probabilities are assigned to each outcome, and the eNPV of the project is the weighted average of the three NPV calculations.

When projects are all or nothing in nature, this is an appropriate response. However, many projects have naturally occurring stages, or can be made to have stages, which implies that the full investment required to implement a given project is not made all at once. Rather, an organization can invest some money to learn something about how best to pursue an opportunity in order to maximize both the probability and the magnitude of a favorable outcome. In such instances, even eNPV approaches are inadequate, because they penalize potentially valuable flexibility in implementation.

To see why, consider two possible cash flows associated with launching a new product. In the first instance, the product is launched at a cost of $175. The eNPV of this launch is $1.19.

A TRADITIONAL EXPECTED VALUE CALCULATION



*The discount rate used here, and in the example on the following page is 5%.

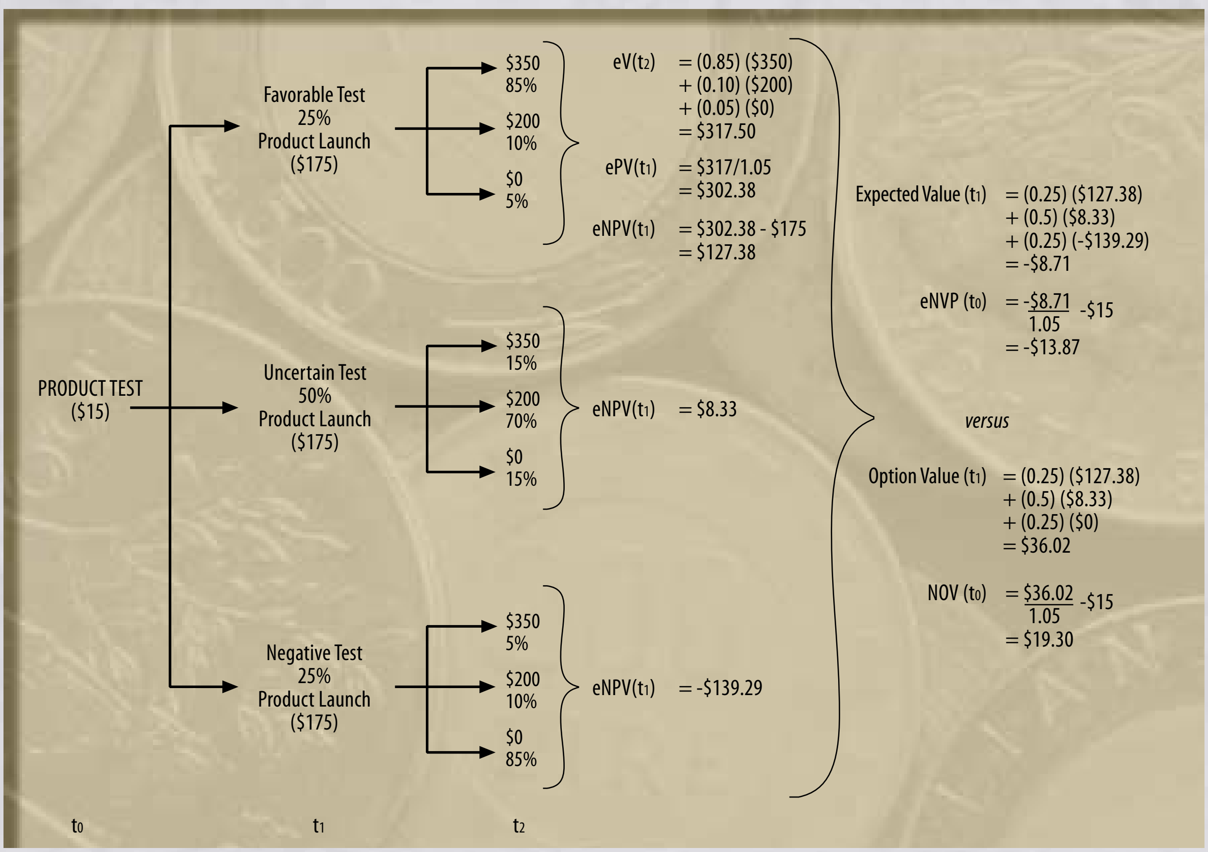
Implementing a preliminary market test, at a cost of $15, allows the firm to update its assessment of the probability of the high, medium, or low outcomes. In eNPV terms, however, the test serves only to increase the negative cash flows at the outset (due to the cost of the test) and delay the positive future cash flows by one period. As a result, a market test serves to depress the eNPV of the product launch to -$13.87. The test would appear to be a bad idea (see box).

What this approach ignores is that managers can respond to the information that the test gives them. Specifically, if the test has an unfavorable outcome, the NPV of a product launch is significantly negative: – $139.89. Consequently, the product would not be launched at all if the test were negative. If the test results are uncertain or positive, the NPV of a launch is above $0 – at $8.33 and $127.38, respectively – and so a launch makes sense.

The test, in other words, can be seen as an option on the launch: it purchased for the company the right, but not the obligation, to make further investments, namely, the $175 required the launch the product. At a cost of $15, the test yields a present value to the overall project of $34.30, since the expected negative present value of launching in the face of a negative test result is avoided, and the eNPVs simply the probability-weighted outcomes of results with positive eNPVs. The result is a net option value (NOV) for the project of $19.30 – more than 10 times the eNPV of the product launch with no test, while an eNPV approach to valuing the test yielded a negative NPV.

Finally, it is important to note that flexibility is not always worth the cost. In this instance, if the market test had cost more than $34.30, the most appropriate response would be simply to launch the product, since the eNPV of the launch is positive. A systematic approach to determining the NOV of flexibility provides the information needed to decide when it is worth the investment.

COMPARING EXPECTED VALUE WITH NET OPTION VALUE



Key: eV = Expected Value, ePV = Expected Present Value, eNPV = Expected Net Present Value, NOV = Net Option Value

CIBC, a Canadian Bank, is an example of this process and illustrates the competitive advantage that can be achieved by exercising in the money real options in a timely manner.[16]

In 1987, the Canadian Bank Act passed, permitting banks to acquire investment houses. Within six months, four of the five largest Canadian banks had acquired a major securities dealer. However, no bank actually pursued integration efforts immediately, thereby withholding the significant investment required to merge an investment bank with their corporate banking activities. Effectively, each bank had taken an option on an integrated corporate banking/investment banking capability by *accumulating* the appropriate resource – an investment bank. At this stage, operating this resource meant maintaining separate cultures, compensation systems, and structures for the corporate and investment banking organizations.

In 1992, however, CIBC began to integrate the two arms of its commercial banking division, effectively beginning the process of exercising its option, while all of its main competitors (Royal Bank, Bank of Montreal, and Bank of Nova Scotia) continued to run separate organizations.[17] Grappling with significant culture clash, compensation disparities, and organizational power struggles, senior management's steadfastness in pushing an integration strategy is, in our view, evidence of at least an implicit belief that the integration option was sufficiently in the money to justify the expense associated with exercising it.

The results suggest that CIBC's timing was appropriate. In 1991, the year prior the first integration efforts, CIBC was a distant third in Canada's investment banking league tables with 9.8 percent of total underwritings, compared to the Royal Bank's 17.1 percent and Bank of Montreal's 16.6 percent. By 1997, CIBC was in first place with 13.5 percent of total underwritings, with Royal in second at 11.4 percent, and Bank of Montreal in third with 9.7 percent. CIBC's dominance appears persistent in a historically volatile industry, for by 1999 the bank's total underwritings were more than double its closest competitor, and it had advised on 10 of the 25 largest transactions in Canada while no other institution, foreign or domestic, showed up more than five times. Industry observers attribute this success largely to CIBC's unique ability to bundle loans, equity, and investment banking services – a capability that appears to compensate more than enough for its much smaller retail sales force, and one that owes to the decision to exercise its option.[18]

Operating a real options strategy also requires an ability to walk away from deals that are not fulfilling their strategic promise. For example, in 1996 the Bank of Montreal (BMO) acquired a 16.2 percent equity stake controlling 20 percent of voting shares, along with eight seats on the 44-seat board of Grupo Financiero Bancomer (GFB). At the time, GFB was the second-largest bank in Mexico.[19] As described by then-CEO Matthew Barrett, the intent was to take a meaningful position in "something that is outstanding and has the potential for significant growth."[20]

More specifically, GFB, and its main banking arm Bancomer, created an option for BMO to complete its NAFTA-inspired triptych, which began with the bank's 1984 acquisition of Chicago-based Harris Bank. With material influence over the operations of major financial institutions in all three signatory countries to the North American Free Trade Agreement, BMO hoped to provide cross-border project finance, cash management, and other services to companies operating in all three jurisdictions, thereby becoming a NAFTA bank.

BMO hedged its bets, however, providing both incentives for GFB to perform well and backstopping its own investment in the event that the anticipated synergies did not materialize. On the incentive end, BMO granted GFB 10 million options on BMO common stock with a five-year vesting clause. Additionally, if over the five-year period following the transaction, the GFB investment depressed BMO's then five-year historical return on equity of 14.7 percent (for 1991-1996), BMO would be compensated with additional equity in GFB.[21]

Between 1996 and today, BMO and Bancomer pursued a number of collaborative initiatives, among them the development of specialized banking services for migrant workers of Mexican origin working in Canada's agricultural sector, with similar services targeted at the Hispanic population living in areas served by Harris Bank.[22] Ultimately, however, the opportunities for significant synergies turned out to be limited. Additionally, consolidation pressures within the Mexican market were forcing ever-greater degrees of integration among Mexican banks, which served to limit the resources and attention Bancomer could devote to exploring cross-border linkages made possible by NAFTA. Finally, the Mexican government had instituted new capital requirements for its banks that would have necessitated significant additional investments by BMO if it were to maintain its stake.

The result was that over a period of months, concluding in March of 2001, BMO disposed of its stake in GFB, selling to Banco Bilbao Vizcaya Argentaria (BBVA) of Spain. BBVA was the logical buyer, as it had been building a stake in Bancomer as an option on its own Latin American growth strategy. BMO recorded an after-tax gain of C$271 million on the deal.[23]

BMO's initial investment in GFB can be seen as creating an option on future synergies between Mexican, American, and Canadian banking operations, just as CIBC's acquisition of an investment banking firm created options on synergies between corporate and investment banking. In the event, BMO's cross-border synergy option never came into the money, and so the bank never committed the additional capital required to integrate the three operating companies. Instead, it disposed of the option at a profit, realizing an estimated annual financial return of almost 10 percent on its initial acquisition price of $456 million. Furthermore, these returns in no way reflect the worth of the shareholder value that was protected as a consequence of hedging a potentially significant strategic risk.

The phases of the Strategic Flexibility framework have been illustrated using examples from a wide variety of FS organizations. See *Royal & Sun Alliance: Strategic Flexibility Case Study* for an application of all four phases to the activities of a single firm.

Royal & Sun Alliance
STRATEGIC FLEXIBILITY CASE STUDY

Royal & Sun Alliance (R&SA), formed in 1710, is one of the world's leading insurance companies with operations in over 50 markets. It continues to develop on an international basis, leveraging its core skills, which include claims handling, risk assessment and control, pricing, and outstanding customer service. R&SA is achieving this growth by taking a strategic view of the ebb and flow of market developments and mapping those changes to its core capabilities. The company is also applying similar criteria to its venturing unit, which focuses on new opportunity development.

ANTICIPATE

As part of the overall planning process, R&SA develops a multi-scenario view of the future, identifying and analyzing the future drivers of change. R&SA's global development scenario planning activities have identified two types of geographical markets based on future prospects and ability to deliver in these markets. This has involved scenario building across a range of critical business areas. For example, in distribution, scenarios included one dominated by self-service, Web-enabled direct channels driven by the successful deployment of a widely accessible, high-bandwidth information infrastructure. Another, driven by less compelling technology offerings and customer resistance to low-touch distribution, was characterized by face-to-face intermediations as the major source of revenue.

FORMULATE

R&SA has identified core and developing markets within its portfolio of companies and brands. Core markets, representing in the order of 90 percent of the business, have been identified as United Kingdom, Scandinavia/northern Europe, Australia/New Zealand, Canada, and United States; while developing markets are primarily Latin America and Asia, with India and China receiving particular focus. This portfolio of markets allows the business to navigate both positive and negative scenarios. For instance, should competition stiffen and revenues be squeezed in some developed markets, new revenues can be sourced from developing markets investments. In this respect, part of the company's strategy for navigating an unpredictable economic landscape is to pursue only the most promising opportunities as they present themselves in various countries around the world. Achieving this implies a core strategy that consists of developing a global model of sharing knowledge and costs across the group's various investments in different countries. Contingent strategies consist of scaling up or down the investment in a given country as circumstances dictate.

ACCUMULATE

Executing the core strategy has required the development of a global intranet platform to facilitate knowledge transfer across company locations. This allows the company to compare opportunities effectively and take action accordingly. Pursing contingent strategies has required making initial investments in new markets that are relatively small in scale, but that support entrepreneurial activity while still drawing on the group's core capabilities through the global intranet. A recent start-up office in Korea is an example of this, another investment in a long line of options on potential growth markets.

OPERATE

The execution of this strategy is a continuous process for the group. The dynamism of the group's efforts is evident in how it manages its portfolio of international investments. For example, the group made an initial small investment in Taiwan, but revenues have not matched the criteria stipulated for expansion. Therefore, the firm has withdrawn from this market, essentially abandoning the option that the first foray into Taiwan represented. At the same time, other investments, such as those in Mexico, have performed well, resulting in expansion – thereby exercising that option.

Implementating Strategic Flexibility[24]

The four stages of *Anticipate*, *Formulate*, *Accumulate*, and *Operate* help executives cope with and potentially exploit uncertainty. But this is only part of the battle. Implementing the four phases of the Strategic Flexibility framework requires both a very different approach to the planning process itself and a complete rethinking of the role of the corporate office in a large, diversified, complex organization.

Planning for Strategic Flexibility

Perhaps the most challenging implication of taking a flexible approach to strategy is accepting the notion that traditional approaches to planning and budgeting are genuinely dysfunctional. The standard planning process begins, typically, with financial projections that are then translated into specific operational imperatives. Such an approach is, at its core, still rooted in a single prediction of the future.[25] Plans that are translated into objectives become commitments, and the essence of good management becomes defined as delivering on those commitments.

In contrast, flexible plans define the range of actions a company might take and the conditions under which it will take those actions. In other words, strategy is no longer about making commitments, but is instead about articulating contingencies. Good management is then characterized by responding appropriately to new information and knowledge as it is gained, whether this means expanding, idling, or even abandoning a project.

A second important difference is that traditional planning cycles are typically annual, with multiyear projections updated in a predictable fashion according to a predetermined schedule. As a result, these processes are calendar driven and repetitive. The Strategic Flexibility framework, however, is *event* driven and *iterative*, and this is perhaps one of the most important elements of planning for flexibility. The Strategic Flexibility framework is a loop, with *Operate* connecting back to *Anticipate* in order to capture these characteristics. As an organization *operates* – which consists of testing new business models, responding to the results, and monitoring the environment in order to determine when and how to exercise or abandon options – it must also constantly update its scenarios. New developments in the drivers of change that shaped the scenarios in the first cycle through the framework will serve to resolve some uncertainties while creating new ones. Consequently, some scenarios will become impossible. Other scenarios will become less likely, and entirely new scenarios might need to be developed – a process greatly facilitated by the highly-structured approach of the *Anticipate* phase.

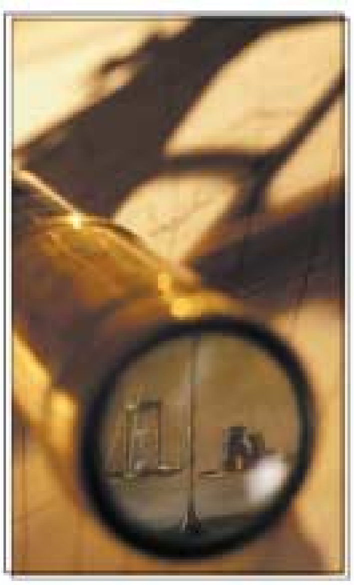
For example, with respect to the payments system in Europe, the evolution of the region's regulatory framework will undoubtedly feature prominently among the drivers of change that define the relevant scenario space. As various EC units and national governments promulgate specific directives, laws, policies, and other guidelines, some issues will be resolved, certain aspects of the overall pace and direction of regulation will come into focus, and new questions and dilemmas will form. Meanwhile, drivers of change other than regulatory policy could assume new prominence. This will invariably alter the scenario space facing financial services companies.

Changes in the scenario space that bound one's uncertainty about the future have a ripple effect through the framework, requiring an updating of all subsequent phases. New strategies must be formulated for the new scenarios, the core strategy revisited, and new contingent strategies articulated; new resources must be accumulated, and perhaps new options on specific capabilities taken. The result is a new set of priorities that drive the operation of the strategy. Consequently, planning documents manifesting a flexible approach to strategy must be what planning documents rarely are: dynamic, actively-referred-to playbooks.

The means to operate flexible strategic plans and the ability to respond effectively to change can be greatly facilitated by the careful application of *program management* (see *Program Management and Strategic Flexibility*). Using this approach, managers can rapidly synthesize new information quickly and understand how a range of actions might affect existing plans, and how interdependencies between different projects might play out. Actively managing a portfolio of options ensures that the organization maintains control over its responses to a complex and evolving web of scenarios.

Finally, a truly flexible approach to planning scales within an organization. The examples adduced so far have tended to be at the level of the largest issues facing financial services organizations: focus versus scope, the evolution of the payments system, and coping with international expansion. As one drills down in any company or any given operating unit, however, the future is similarly fraught with uncertainty – at no level is it possible to predict with certainty. How should the insurance division of a bank cope with the demutualization of its insurance-focused competitors? What sorts of partnerships should the online division of a brokerage house establish as it expands its product line? How will the residential mortgage market evolve?

Since each of these questions can be addressed using the four-stage Strategic Flexibility framework, it provides a common set of concepts for developing and implementing strategy at all levels of an organization, and for valuing the flexibility required to cope with uncertainty.



Program management and STRATEGIC FLEXIBILITY

Program management is the coordinated management of a portfolio of projects to achieve a set of business objectives. While still a relatively new discipline in the management arena, program management is now associated with a disciplined approach to the management of a complex array of projects, initiatives, and plans. Its secret lies in understanding the sum of the parts to make explicit linkages between the execution of projects, initiatives, and plans and overall business objectives. In the context of Strategic Flexibility, program management provides a practical set of tools to help executives understand the constituent parts of their various contingent strategies. In its application, program management brings a process-oriented focus to viewing the portfolio of activities, including the following:

Value: Focusing on the measurement, monitoring, and delivery of value to shareholders and other stakeholders

Risk: Ensuring that all potential internal and external risks are formally identified and monitored

Organization: Providing an organizational structure to govern the program that reflects the culture of the enterprise

Structure: Providing the means to observe a holistic view of the entire portfolio, enabling proper coordination and timely decision making

Resources: Overseeing the management and allocation of scarce resources to prioritized strategies and plans

Communication: A formalized process for disseminating vital information for decision making and building commitment

Capability: Building internal skills to meet the needs of programs

Program management defines the big picture. It presents enterprises with the ability to prioritize multiple plans and initiatives in order to achieve strategic change. It not only interprets the enterprise's strategy and provides a framework for its delivery, but it also provides input to the development of the strategic plan by emphasizing what can be achieved.

The Role of the Corporate Office

Conventional wisdom holds that, in the face of turbulence, decision-making and strategy formulation must be pushed down to the lowest levels possible in an organization. This view is justified by the belief that uncertain environments are characterized by rapid change and, consequently, windows of opportunity are narrow. Passing information up and down a traditional hierarchy introduces time lags in decision making that doom a company to miss fleeting opportunities to seize a momentary competitive edge.[26]

Devolving authority is arguably the right approach if the objective is to create an organization that is *nimble*, as opposed to *flexible*. Nimble organizations attempt to respond to the environment around them by changing just as fast as it does. And if it is possible to acquire the necessary resources, restructure and reorganize in an appropriate manner, and develop and deploy new products and services with a clock speed at least as rapid as each of markets, technologies, competitors, and regulators, then a strongly decentralized approach has considerable merit. Managers deal with uncertainty by developing an organizational capacity for change so finely honed that the organization can spin on a dime and respond in real time as any given dimension of uncertainty is resolved.

However, in the financial services business, as in telecommunications, high tech manufacturing, media, utilities, pharmaceuticals, and other asset-intensive industries subject to the dilemma of having frequently to make big bets in the face of an unpredictable future, responding in real time as uncertainties are resolved is frequently not a viable alternative.

The answer is advance preparation that makes it possible to change quickly by calling upon capabilities that have been developed for just such an occasion. For almost all of the examples above – be it AIG's move into China, CIBC's move into investment banking, or Barclays' move into mobile banking – there is tremendous advantage to moving quickly to lock up potentially valuable partners well in advance of knowing precisely when or how a specific partnership will prove valuable. This is known as a first mover advantage with respect to pre-emptive asset acquisition.[27] However, being forced to secure the necessary resources does not mean being immediately forced to invest in combining and integrating them.

When an organization accumulates the resources it needs through these types of portfolio plays, decentralized decision-making processes are generally inadequate. Making such investments requires the sort of long-term perspective and horizon-scanning capability that is typically beyond the mandate of operating division leaders who, justifiably, tend to concentrate on the needs of their own divisions. Consequently, creating flexibility is uniquely the purview of the corporate office.

Perhaps the most delicate element of implementing a flexible approach to strategy is the need to preserve the value of the real options that are its foundation. Clearly, the *Accumulate* phase of Strategic Flexibility implies some level of diversification. Citigroup is an extreme example of this, but many large financial services institutions are pursuing similar portfolio-level approaches. How best to manage a diversified firm has long been the subject of debate, and many have settled on the notion that divisional autonomy is a critical element of successfully managing the multibusiness enterprise. Even when interdivisional cooperation is potentially valuable, the bias in most management circles is for division-level executives to be granted extremely wide latitude in determining when and how to pursue synergies.[28]

However, when much of the value of a particular division lies in the fact that it has been nominated to contribute to achieving certain synergies that would be valuable under certain possible future conditions, a bent toward divisional freedom can destroy value. For example, successfully bundling products requires an integrated customer relationship management capability. If individual divisions pursue systems that are optimized to their current needs but are incompatible with each other, the real option that the multiple business units represent on future bundles will be compromised. Consequently, significant constraints on divisional activities are sometimes needed in order to ensure that the possibility of integration is not sacrificed in the interests of current division-level performance. In this example, these constraints would take the form of compelling divisions to adopt compatible systems.

At the same time, these restrictions must not prevent divisions from competing effectively (if not necessarily optimally) on their own. If the constraints required to preserve real option value jeopardize a division's viability as a standalone entity, the corporate parent undermines its ability to abandon options that are out of the money. In the BMO-GFB case, for example, had the Bank of Montreal created tightly integrated back office systems in the pursuit of either cost-cutting or initial synergy-seeking efforts, it would have been that much more difficult and expensive to disentangle itself when it became clear that the NAFTA-bank scenario was not playing out. As with the portfolio-level decisions that create real options-based flexibility, determining the appropriate balance between corporate direction and divisional autonomy is something that must similarly happen at the corporate level.

Finally, in the *Operate* phase, companies must determine when a given option is in the money, and so should be exercised, or out of the money, and so should be abandoned. It is here that the role of the corporate office is most visible and critical.

Exercising options is fundamentally an entrepreneurial activity, and so it is no surprise to see that those companies that have demonstrated the highest levels of this kind of integration have some of the most operationally inclined CEOs in industry. For example, despite radically different personal styles, Sumner Redstone at Viacom (the communications giant and parent company of CBS) and Martin Sorrell at WPP (the world's largest and most diversified corporate communications firm and parent company of Ogilvy & Mather) do not appear to focus on process issues or leadership succession the way such legendary managers as Jack Welch at General Electric or Larry Bossidy at the former AlliedSignal are reported to have done.[29] Rather, they are deeply involved in determining and driving when and how once autonomous and independent divisions should begin to cooperate in order to capture the value of synergies in the face of changing competitive pressures.

Abandoning options requires just as much, if not more, direction from the corporate office. Much of an investment's option value typically lies in the flexibility to avoid making money-losing investments; no one would ever exercise a financial option that was out of the money, and the same should apply to real options as well. The problem is that organizational politics frequently intervenes and specific projects end up remaining funded long after any reasonable hope of turning a profit has evaporated. Falling victim to the sunk cost effect is a well-documented organizational phenomenon, in which managers keep sinking projects afloat in order to avoid having to admit they were wrong in their initial support of a now-failing undertaking.[30]

When organizations are unable – typically for political reasons – to fold a losing hand, abandonment value is entirely imaginary. For most organizations, in the short-term at least, overcoming these political pressures and terminating losing projects quickly usually requires the same kind of corporate executive intervention required to exercise real options.

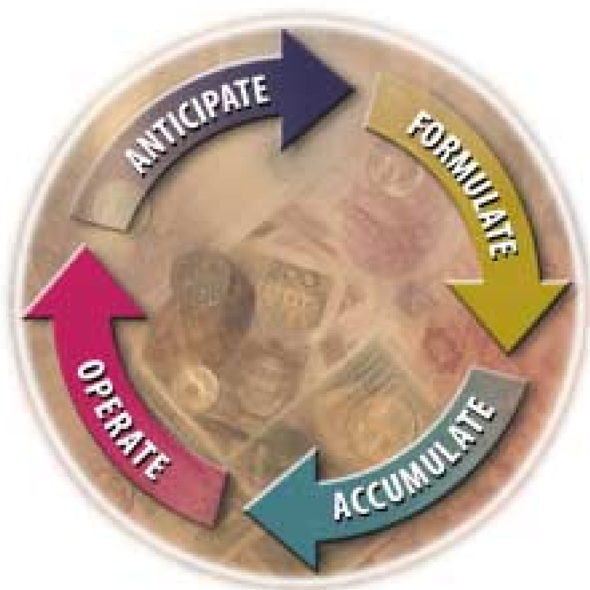
Conclusions

Today's financial services landscape is more challenging than it has ever been. As forces such as technology, regulation, and globalization impinge on established industry boundaries and time-tested revenue models, companies are being forced with alarming frequency to revisit their most fundamental assumptions about their businesses and how best to position them to compete.

The decisions required in many cases seem to place strategists in a classic dilemma: uncertainty surrounds which bets to place at the same time that competitive pressures preclude waiting for that uncertainty to be resolved before acting.

Strategic Flexibility is the answer to this dilemma. The range of possible futures is defined through a highly-structured approach to scenario-based planning in the *Anticipate* phase. Optimal strategies are defined by drawing upon the time-tested methodologies of conventional strategic planning, and then merged to create core and contingent strategies in the *Formulate* phase. The *Accumulate* phase consolidates new thinking about real options and the value of flexibility to provide a rigorous process for building an arsenal of capabilities and resources that will provide for the firm's success across a wide range of possible futures. And finally, a new concept of the corporate office and the strategic planning process itself constitute the tools needed to *Operate* the resulting diverse – yet flexible – organization.

Taking the prescriptions of this report seriously is not a trivial task. For many companies it will require a fundamentally new approach to processes that are fundamental to organizational life, including corporate-divisional relations, executive evaluation and compensation, strategic planning, and investment valuation. However, given the magnitude of the challenges facing today's leading financial services firms, only such a thorough going approach will suffice. Extraordinary times demand an extraordinary response.



Endnotes

[1] As an example of this, note that for most its history Bank One had outperformed the S&P Diversified Financials index as it successfully executed a seemingly unending string of acquisitions, rolling up dozens of small regional banks. With the advent of interstate banking, Bank One undertook a series of acquisitions that were materially larger than it had historically pursued resulting in a fundamental change in strategy. Coincident with this change in strategy, the firm has since underperformed its peer group. See Jpward Business School case studies Banc One1993, and Banc One 1996.

[2] International Data Corp., October 2000 forecast.

[3] Forrester Research, as cited in Deloitte's "Re-Inventing Financial Services Business Models" report, p. 4, published in 2000.

[4] Charles Schwab Corp. first quarter 2001 press release.

[5] One can hardly look to the capital markets for meaningful direction with respect to which companies will succeed, especially in the wake of the bursting of the Internet bubble: based on calendar year 1999 valuations, Amazon.com had a market capitalization of over $26 billion, while Lehman Brothers was capitalized at just over $9 billion and Mellon Financial Group at $17 billion.

[6] From 1992-2000, BONY outperformed the S&P Major Regional Banks index by an average of 19.4% each year. For the same period, Citigroup outperformed the S&P Diversified Financial Services index by an average of 13% each year. Of particular note, after dipping below its peer group in 1998 in the wake of the announced Traveler's merger, since 1999 Citigroup has outperformed its relevant peer group by an average of over 19% per year.

[7] As quoted in "Sandy Weill's Monster", Fortune, April 16, 2001.

[8] Electronic Payments International "Brokat enables Vodafone mobile payments" May 2001.

[9] Porter, M. E. (1980). Competitive Strategy. New York, Free Press.

[10] See Perrottet, Charles M. (1996). "Scenarios for the Future," Management Review (January).

[11] In addition to Porter (*op. cit.*), see Brandenburger, A. M. and B. J. Nalebuff (1996). Co-opetition. New York, Doubleday; and Prahalad, C. K. and G. Hamel (1990). "The Core Competence of the Corporation." Harvard Business Review (May-June): 79-91.

[12] Strategy & Business 2001.

[13] For more on managing mergers and acquisitions, see "Solving the Merger Mystery," published by Deloitte Touche Tohmatsu and available at http://www.dttgfsi.com/publications/research.html.

[14] For more on strategic risk, see "Risk Management in an Age of Change," published by Deloitte Touche Tohmatsu and available at http://www.dttgfsi.com/publications/research.html.

[15] As a company assembles an increasing number of contingent use resources, it can find itself with a new challenge: managing a portfolio of relationships, each of which constitutes an option on a particular capability. For more on this topic see "The Relationship Portfolio: Intelligent Partnering in the New Global Economy", published by Deloitte Touche Tohmatsu, and available at http://www.dc.com/research.

[16] See "CIBC Corporate and Investment Banking" cases (A), (B), and (C), published by Harvard Business School, written by Michael E. Raynor.

[17] Toronto Dominion (TD), at the time the fifth largest Canadian bank, pursued a very different strategy, wagering on the power of investing in retail distribution rather than attempting to build a particularly strong underwriting capability. TD first established its discount brokerage, TD Greenline, which then became part of TD Securities. The strategy culminated in the acquisition of Waterhouse, which became TD Waterhouse, a highly successful online brokerage.

[18] Globe & Mail, April 1, 1999.

[19] Globe & Mail, March 30, 1996.

[20] Globe & Mail, November 26, 1996.

[21] Globe & Mail, March 30, 1996; Wall Street Journal, February 28, 1996. None of these provisions were exercised due to material dilutions in BMO's equity stake in GFB as BBVA increased its investments in the Mexican bank.

[22] Globe & Mail, September 18, 1999, and August 18, 1999.

[23] Regulatory News Service, May 4, 2001.

[24] For more on the organizational implications of pursuing a flexible approach to strategy, see Raynor, M. E. and J. L. Bower (2001). "Lead from the Center: How to Manage Divisions Dynamically." Harvard Business Review 79(5): 92-100.

[25] See Kaplan, R.S. and D. P. Norton (2000). "The Strategy-Focused Organization: How Balanced Scorecard Companies Thrive in the New Business Environment." Harvard Business School Press. This work is an excellent example of linking financial target to strategic goals, but does not address explicitly the challenges of flexibility.

[26] See, for example, Chakravarthy, B. (1997). "A New Strategy Framework for Coping with Turbulence." Sloan Management Review 38(2).

[27] See Lieberman, M. B. and D. B. Montgomery (1988). "First-Mover Advantages." Strategic Management Journal 9: 41-58.

[28] See Goold, M. and A. Campbell (1998). "Desperately Seeking Synergy." Harvard Business Review (September-October): 131-143.

[29] See Tichy, N. M. and R. Charan (1995). "The CEO as coach: An interview with AlliedSignal's Lawrence A. Bossidy." Harvard Business Review 73(2): 68-79.

[30] See Garland, H. 1990. "Throwing good money after bad: The effect of sunk costs on the decision to escalate commitment in an ongoing project." Journal of Applied Psychology. 75: 728-731.

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