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First-Generation Internet Banking – Bankers' Perceptions of the Threat

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Abstract. This paper is based on contemporaneous surveys of the banking industry in the UK and eurozone during the period 1999–2001. The study looks at the development of first-generation standalone Internet banks and the threat they represented to the established industry. The paper shows that bankers were clearly concerned by the impact of Internet banking and the potential it generated for increased levels of new entrants into the industry. However, the concern was not necessarily that the market structure would be irrevocably changed, but that the Internet banking revolution would change competition between established players. While entrepreneurs (both from outside the industry and within established institutions) grabbed the opportunity to create mould breaking businesses, the established competitors believed that such new players would not survive in the long run. The Internet would cause change, but the ultimate competitive landscape would be little changed. This indeed proved to be the case. Nevertheless, the industry did recognise that the new players were changing the nature of channel delivery in the financial services sector and the way it communicated with customers.

Keywords: internet banks, multi-channel, e-banking.

1. Introduction – Standalone vs. Integrated Ecommerce Models

Banks are not always renowned for their entrepreneurial spirit. During the dot.com bubble period this was to change. Three new models started to challenge the old order:

- New entrants were entering the market. The prime example of this, often claimed to be the first Internet-only bank, was Security First Network Bank formed in 1995 (Mahan, 1996 – see case study below)

- Firms once rooted in one section of the industry were branching out into other sub-sectors. A clear example here is the UK's Prudential insurance group which formed the start-up bank Egg which was launched as an Internet bank in 1998 (Harris, 2003)

- Traditional banking groups reacted to these challenges with their own start-up enterprises. Cahoot, for example, was a UK Internet-only bank formed as a subsidiary of Abbey 2000 (Marketing, 2000)

The "Internet-only" banking model was part of what was seen as the fast growing e-commerce market. Enormous expectations of growth were built into extraordinarily generous investment criteria for any project that was "e-commerce". However, such environments can, and indeed usually do, attract a raft of new competitors for whom traditional investment criteria are often put to one side and, more critically, the full power of barriers to entry are ignored. Such an environment occurred in many parts of the e-commerce boom economy. The phenomenon was described as an "unsustainable glut of competitors attracted by forecasts of high growth and promises of exceptional returns" by Day, Fein and Ruppersberger (2003) in their analysis of B2B Exchange markets. Day, Fein and Ruppersberger (2003) counted more than 140 new entrant exchanges in the industrial supplies sector, 110 new exchanges in the food and beverages sector and a further 55 in construction supplies. Similarly, the banking industry attracted a raft of new entrants based on the market opportunity afforded by Internet channels. Day, Fein and Ruppersberger (2003) note that when there is the promise of high growth, "Even when the market is already crowded, more entrants keep arriving. These followers are often naïve about the barriers to entry and don't realize how many others are also poised to enter at the same time." This was to prove the case for many start-up and spinoff Internet-only banks.

It can be argued that those who established these banks (or offshoot banks) should have realised they faced very large barriers to entry despite the then common claims that the Internet created a new economic rule book. This was an era when the barriers to entry to an industry were often simply ignored. Porter described this as a period when many commentators and even some influential decision makers turned their back on "strategy" and instead relied on the "New Economy" and "new business models" (Porter, 2001). Porter argues that far from making markets attractive, the Internet-based strategy could make some markets less attractive. The Internet's tendency to reduce profitability (by increasing the power of buyers through increased transparency) could simply reinforce competitive advantages, as firms need to operate in a new tighter-margin environment. Indeed its impact may well have been to reduce the appeal of certain markets – general insurers with margins ravaged by price comparison services may well agree.

Such a view would suggest that the potential winners from e-commerce would be those that could bring to bear the full weight of their entrenched competitive advantages. However, two problems existed. Firstly integrating e-commerce channels with traditional operational structures to gain joint economies of scale was a challenge for all established enterprises, indeed established enterprises tended to see a rise in the cost of sales through the additional cost of adding e-commerce channels (Zhu and Kramer, 2002). At this stage e-commerce was very much focussed upon e-sales and e-marketing and the ability to integrate supply chains was limited (van Hoek, 2001). The second key challenge was presenting an easy to use customer-centric model to customers and, at least in the

early stages, it was easier to achieve this through stand-alone Internet banks than through integrated models (Hughes, 2003).

Thus, the debate at this time was between those who believed the fundamentals of economic decision making and competition would not be undermined by the Internet and those who saw, at least in the short term, barriers to traditional firms being able to compete in these markets using the full competitive weaponry that they had built up before the web "changed everything".

1.1. Standalone Internet Banks – or Not

One of the most notable factors in the development of standalone internet banks was that they were very rarely standalone. The main model was the establishment of Internet banks as separate subsidiaries of established financial services groups. The reasons for this were:

- There was a gloss to having an Internet banking capability
- Some customers were perceived as demanding the service
- Traditional core banking systems (the account keeping, payment and processing technologies behind the bank) were vast and complex systems developed over many years which could not easily be adapted to support a user-driven channel

In addition, established groups had a branding challenge (Harris, 2002). Most did not use a differentiated branding strategy, and yet they would find it next to impossible to introduce Internet banking at a reasonable cost for their established brands. This, coupled with the fact that most online entrants to the industry offered better rates to attract new customers than established institutions, meant that traditional banks needed to consider how they could offer competitive capabilities, without damaging their established relationships with higher margin customers. This led to a proliferation of new-branded entities from established institutions.

Therefore, entrepreneurship in the Internet banking market was in the main driven by innovation groups in larger institutions looking to use the Internet-only model to establish new reach, drive down costs and add kudos – while avoiding the very high costs involved in being a first mover into Internet banking using the main banking systems.

Even the bank heralded as starting the Internet banking revolution, Security First Network Bank was supported by larger groups and was spun out of a

traditional banking background (to later be reincorporated into another larger group):

Mini case study - Security First Network Bank

Security First Network Bank was the first of a new breed of Internet only banking institutions. SFNB would have a profound impact in the market and, while as a bank it was insignificant, the lessons learned and the software technologies that came out of it would be in part responsible for many start-up internet banks coming to market.

SFNB was formed in October 1995 by brothers'-in-law James 'Chip' Mahan and Michael McChesney (Lunt, 1995).Mahan's background was in commercial banking where he had previously established Atlanta-based Cardinal Bancshares, whilst McChesney was in technology, and was the owner of SecureWare, an Atlanta-based network security company.

Not surprisingly SFNB was established with a dual remit (Gandy, 1998). The first was to set up the first Internet banking service. The second was to use this to market the associated software to third party banking institutions via a sister technology company. SFNB would act as the technology proving ground as well as a deposit taking institution. Original partners in the venture included regional banks, Wachovia, Cardinal, Huntington, and Area Bancshares (Gandy, 1998). To enable cross state line banking, SFNB was regulated as a savings and loans, with Cardinal Bancshares changing the charter of one of its branches with the Office of Thrift Supervision to provide SFNB's one and only bricks and mortar branch.

In February 1998 the banking element of the start-up, SFNB itself, was sold to the US subsidiary of the Royal Bank of Canada. Prior to this the technology subsidiary, initially called Security First Technology and then S1, was spun out.

The banking element of the SFNB development proved the ability to attract customers to this channel. On acquisition by Royal Bank it had deposits of $54.7m, loans of $14.3 million, and securities holding of $46.5 million. At the time of launch it estimated that while the usual overheads of a traditional branch structure were 3.5% it was looking at overheads of around 1%. The average customer was 35 years old with income of $65,000, based on the initial customer base in 1995 (Gandy, 1998).

However, this was small in comparison to being early to market with a new generation of Internet-ready core banking software. For the entrepreneurs behind it the SFNB created a much greater (though related) success through S1. By 2001 the S1 Corporation supplied software to more than 3900 companies, mainly in the financial services sector and as of 2008 is still a major supplier of internet-enabled core banking systems.

It is interesting to note, however, that while they were clearly wedded as an organisation to the promotion of Internet-banking, their own experience in

running an Internet-only bank showed the limitations of the electronic-only strategy. Their annual report from the transition year of 1998 noted that:

> *Most financial services providers focus on the delivery of traditional financial services over the Web as a means of cutting costs. Based on our experience of operating the first Internet bank, we believe that, in fact, there are additional support and delivery costs associated with online banking. As a result, S1 has always maintained the importance of maximizing an institution's revenues to sufficiently offset those additional costs. (Security First Annual Report, 1998)*

2. The Case for Standalone Internet Banks

Those making the decision to enter the Internet banking arena during the period 1999–2001, whether as start-ups or established firms adding a new channel, would have been greatly influenced by the writings of journalists, consultants and academics in the immediately preceding few years.

In the late 1990s Internet banking was seen as a major force for change in the financial services sector. In December 1995 the cover story of the *American Bankers Association Banking Journal* was dedicated to the first Internet banking services, Security First Network Bank – the subject of the mini-case above. There was much excitement with the launch of SFNB. It was noted in the article that 'During the bank's first two weeks on the Internet, 750 people from 32 states opened an account at it, a third of them from California'. It went on to quote the CEO who added, 'Let me put that in perspective for you . . . We started a traditional bank from scratch in Louisville a year ago, and that bank in 12 months has opened 187 accounts' (Lunt, 1995).

The 'paradigm shift' element from the title of the article was a comment on the scale of the Internet market and the enormous benefits of using it as a vehicle. The 12 million people then on the Internet in the US were expected to grow to 22 million by 2000 (Lunt, 1995). More important than the sheer numbers was the infrastructural and cost benefit seen as inherent in the Internet-only banking model. 'Banking on the Internet lets this little bank compete effectively against money center giants for consumer and small business accounts all over the country, while maintaining a much lower overhead than banks that rely on bricks and mortar.' (Lunt, 1995)

Three years after the first articles about SFNB.com, Internet banking had come to be regarded as a key strategic expansion of the channel mix. However, as noted in the *McKinsey Quarterly* (Holmsen et al, 1998), not all the benefits were available to all institutions. Those with a legacy channels environment could be left behind by those institutions not so encumbered. The McKinsey article noted that, 'The promise of lower transaction costs, increased sales productivity, and more convenient service has lured banks into setting up new electronic and product-specific channels. But they have quickly found that their delivery

capabilities are outstripping the traditional branch-centered model they use to manage them. As a result, they face stubbornly high efficiency ratios, expected revenues that never materialize, and channel managers at odds with the standards by which they are measured and rewarded.' (Holmsen et al,1998)

One of the key features of the Internet delivery model is that it offers enormous benefits to customers, notably greater accessibility (24/7), while simultaneously slashing the operating cost base. Identifying the cost of Internet banking versus the cost of traditional channel structures became an important driver for the spread of the channel. All the charts and graphs outlined by consultants and the media showed Internet banking as a significantly cheaper channel than traditional branches. The evidence put forward suggested that each financial service transaction conducted over the Internet would be just 1% of the cost of a branch-based transaction (Lowe and Kuusisto, 1999). It was estimated that the cost of an average transaction conducted in a branch environment was $1.07 while the average Internet transaction cost just 1 cent:

These were order-of-magnitude differences in cost; it is no surprise that banks got excited, as did potential new entrants to the industry. Commenting on similar numbers presented by the consulting firm McKinsey, the OECD (Van den Berghe et al, 1999) noted that, 'These new trends will force financial institutions to reinvent – but not eliminate – the traditional face-to-face channels . . . it is, however, clear that the role of traditional insurance agents or bank branches may shift.' (Van den Berghe et al, 1999).

Such impressive per-transaction cost savings are very appealing and many, if not all, institutions have sought to achieve them by managing customers and encouraging the use of new channels. It was also seen as enabling new entry into an industry which, despite being a service industry, required high levels of investment to access. Lowe and Kuusisto (1999) believed that such cost differences between old and new channels enabled entry and would impact the nature of the financial services market: 'The intangible nature of financial services facilitates swift copying of new ideas and the number of products and services on offer is constantly growing. Thus markets for financial services are becoming fragmented and very dynamic with the emphasis on price. New market entrants tend to be aggressive and able to target banks' most profitable customers by offering competitive, innovative services, which do not require any physical presence.' (Lowe and Kuusisto, 1999)

The radically lower costs offered by the combination of an automated back office linked to customer-driven electronic channels was seen as changing the competitive landscape of the industry. It became cheap to be in financial services because the huge costs associated with distribution and the barriers to entry created by distribution costs had been undermined. It seemed, for a while, that the

barriers had completely come down and it was now cheap to reach both regional and global markets.

One of the key challenges was seen as being the migration of as many customers as possible to allow the greatest cost savings to be realised through channel substitution (Mendonca & Nakache, 1997). As the consulting group McKinsey made clear, established institutions must reduce the traditional branch network and migrate as many customers as possible to the new low-cost channels to try to contain costs (Mendonca & Nakache, 1997).

To achieve this goal, institutions were looking to re-educate their customer bases to use the new channels, which in turn would allow them to slash their traditional distribution networks (Lowe and Kuusisto, 1999). However, this could be at a great cost. Lowe and Kuusisto (1999) suggested that 'fragmentation' of the industry caused by new entrants joining the market based on the new low-cost models would undermine the 'institutional stature' that financial services companies, mainly banks, enjoyed in the community. Their stature was based on presence in the community and it was this that presence enabled institutions to offer value-added services.

Lowe and Kuusisto noted the risks that institutions would be taking if they disengaged from communities in the hunt for lower-cost distribution channel options. Such a disengagement could undermine their status and their ability to sell value-added services as local presence would be lost and 'commodification' of products would take place.

This argument noted the dangers of the Internet to the local banking model. Banks restructuring to compete with low-cost direct-channels-only competitors would undermine their status and be forced down into the myriad of commoditised virtual vendors. While the threat of new channels as a disruption to the structural make-up of the banking industry may not yet have materialised, the removal of local presence and commoditisation of products has indeed taken place in other sectors of the financial services industry. A key example is that of the direct sale of car insurance over the telephone. This distribution channel was quickly joined by the direct sale of car insurance over the Internet, and a major commoditisation of that product set was reinforced by this trend (Pearson, 2002). According to Pearson 'The insurance industry currently finds itself in a revolutionary situation characterized, in part, by the impact of new direct marketing techniques, facilitated by new technologies; by corporate restructuring and the creation of international mega-corporations; and by the accelerating globalization of the industry' (Pearson, 2002).

The basic premise of all the early arguments in favour of Internet banking as a standalone distribution channel was based on a channel-substitution argument. This outlined four key benefits:

- It lowers the per-transaction cost of basic banking operations and allows institutions fully to leverage their increasingly centralised and automated back-office functions.

- It enables branches to be streamlined and re-engineered into lower cost but more attractive environments.

- It frees these new environments to be fully exploited as sales hubs.

- It gives an improved customer experience through longer opening hours and user-driven transactions.

3. Did Bankers Believe in Standalone or Integrated Models? Evidence from 1999–2001

Not surprisingly, banking education bodies, membership bodies, associations and think tanks wanted to understand, or at least help their members understand, how Internet banking would challenge the established order.

During 1999, 2000 and 2001, the ***ifs*** School of Finance (then known as the Chartered Institute of Bankers) conducted three surveys of major financial services groups in the UK and Europe (for a list of participants see Appendix 1). The 1999 and 2000 surveys concentrated on the UK market place; the 2001 survey, which was conducted with support from the European Financial Management and Marketing Association (EFMA), was a comparative survey between Europe and the UK.

The following section outlines the findings of those surveys, though it should be made clear that the responses and findings are indicative only and that the method had natural biases. The surveys were not designed for rigorous academic analysis, but simply as an indicator of how middle and senior management saw the integrated challenges of new channel development and new customer management techniques.

The surveys were undertaken as individual submissions from members rather than formal corporate responses. Respondents were asked how the challenges outlined impacted their own business unit or business area. However, it should be noted that some respondents clearly answered questions from a corporate perspective, using knowledge from outside of their business unit. It is therefore important to note that the findings can only be treated as indicative because of the possibility that multiple 'business unit' responses taking a broader view of the institution than was intended. It may be, for instance, that when a respondent said that Internet banking was offered, they meant by their institution rather than their business unit.

The surveys were aimed at the retail divisions of the institutions surveyed and were answered by middle and senior management (the latter with a greater tendency to make a corporate-level response rather than a business unit response).

The surveys were undertaken for a series of management reports published in the ***ifs***/CIB membership journal *Financial World*.

3.1. 1999-2001 Rapid Growth in Internet Banking Offerings

- Established banks began to move quickly to compete against start-up brands

- Based on the 2001 survey, the UK appeared to be ahead of European banking rivals in the introduction of electronic channels for banking customers (Tables 1 and 2).

- During the period 1999–2001, rapid growth other electronic channels was also seen (tables 2 and 3)

Despite the relative newness of the Internet, by 2001 banks across Europe had bought into the Internet as a means of delivering their services to their customers. With so much channel change going on at this stage, one of the first questions is whether banks were making progress in introducing a new, more customer-friendly channels mix that offered electronic access to their services.

As Table 1 shows, by 2001 the majority (68.43%) of UK banking groups were satisfied with their channel mix, or were progressing towards a satisfactory mix. Clearly, eurozone institutions had made less progress (at least according to their own judgment). Large numbers of banks in France and Germany had not made progress in reforming their channel mix and 60% of German respondents said they were making little progress to change this.

Table 1: Do you believe you have an optimal mix of distribution channels – sales force, branches, electronic channels, call centres (%) (2001)

	UK banks	**Benelux banks**	**French banks**	**German banks**	**Italian banks**	**All euro zone banks**
Yes	42.11	0.00	0.00	20.00	20.00	11.11
Institution is in the process of introducing a new channel mix	26.32	80.00	66.67	20.00	80.00	61.11
The institution is only at the planning stage for a new channel mix	10.53	0.00	33.33	60.00	0.00	22.22
No	21.05	20.00	0.00	0.00	0.00	5.56

It is interesting to see a relative lack of progress in eurozone countries. However, there were significant differences between the competitive environments in which banks were operating in different countries. The UK was a relatively open market and saw an explosion of entrepreneurial new entrants into the market. As Appendix 1 shows, the surveys completed in the UK included returns from institutions built on direct-only electronic models including:

- Egg
- Virgin
- Enba/first e.
- Intelligent Finance

As well as these four institutions built on a direct and Internet offering, the UK also had strong telephone banking offerings from the likes of First Direct (part of HSBC) and supermarket-branded direct banking offerings from Sainsbury (founded 1997) and Tesco (founded 1997). In addition, many established banks were in the process of launching standalone first generation Internet banking brands. Halifax had launched Intelligent Finance (2000), Co-operative Bank had launched Smile (1999) and Abbey was launching Cahoot (2000). The UK was comparatively awash with first-generation Internet banks or direct offerings that predated the Internet. This clearly spurred action by the other banks.

This self-perception that the channel offering was weaker in Europe did not mean that European institutions were not offering Internet banking or other direct technology channels – indeed some appear to have been ahead of the UK in terms of Internet and mobile banking, which seems at odds with Table 1.

Table 2 shows that, by 2001, Internet banking was available from the vast majority of European banking groups.

However, interpretation of these findings does need to be tempered as respondents' interpretations of the different channel descriptions may vary. Table 2 shows that 100% of French respondents note that they have an Internet offering. At this stage all major French banks still offered services through the French Minitel electronic communication network; there is a strong possibility that respondents from French banks interpreted the 'Internet' as 'electronic channels', given that Minitel was not one of the other options on the survey. Certainly one response to the survey notes this as an issue.

Nevertheless, whether in the UK or Europe, it is clear that electronic delivery of banking services was commonplace by 2001. Research from previous years shows how quick the take-up was. Table 3 shows that in the previous year 69.7 % of UK respondents were already using the Internet to distribute products.

Table 2: What channels do you currently offer to customers (%) (2001)

	UK banks	**Benelux banks**	**French banks**	**German banks**	**Italian banks**	**All euro zone banks**
Internet	94.44	80.00	100.00	80.00	80.00	83.33
Interactive television	44.44	0.00	66.67	0.00	20.00	16.67
Telephone	94.44	100.00	100.00	60.00	100.00	88.89
Mobile interactive (WAP)	61.11	40.00	100.00	80.00	60.00	66.67
Branches	88.89	100.00	100.00	100.00	100.00	100.00
In-house sales force	77.78	80.00	33.33	60.00	60.00	61.11
Third-party intermediaries, ie IFAs	50.00	80.00	33.33	60.00	0.00	44.44
Third-party alliances	66.67	40.00	33.33	40.00	20.00	33.33

Table 3: What channels do you currently offer to customers? UK banks only (%) (2000)

Internet	69.70
Interactive TV	6.06
Telephone	100.00
WAP	9.09
Branches	100.00
In-house sales force	87.88
Third-party intermediaries	69.70
Third-party alliances	54.55

These results clearly show very the fast progress in the adoption of Internet banking, which was already well embedded by 2000. The main contrast between 2000 and 2001 was that during the dotcom period banks were very willing to invest in other electronic delivery channels, such as WAP mobile phone banking and interactive television banking. While these were very small channels in 2000, by 2001 44.44% of UK respondents claimed to have interactive television services and 61.11% were offering some form of mobile banking technology. Neither of these technologies would prove to be a hit with customers.

It was in this environment that Internet-only banks had to operate. They had often led the way in introducing electronic banking channels to customers (though electronic banking predated the Internet)

3.2. The Impact of New Channels on the Marketplace

As new channels came into the marketplace, there was an increasing consciousness that they would change the business:

- Customers would become less loyal (Table 4).
- New entrants would flourish (Table 5).
- Electronic services would lead to lower margins (Table 6).

It was clear to bankers at the time that the growth of Internet channels would have a detrimental impact on their ability to retain customers. It was widely held that customers who used electronic channels would be less loyal (Table 4). This feeling was especially strong in the UK and German markets – in the latter there was particular concern that loyalty levels would decline.

Table 4: Do you expect customers using electronic channels to be as loyal? (%) (2001)

	UK banks	Benelux banks	French banks	German banks	Italian banks
Yes	15.79	40.00	33.33	0.00	40.00
No	84.21	60.00	66.67	100.00	60.00

There was a widely held belief that customers of electronic banking channels would move between institutions more freely, whether driven by their nature as younger, more affluent customers, or because of the ease with which bank accounts could be moved using electronic channels. The strategy used by new entrants was also a potential factor. The main entry strategy was to offer highly competitive rates to savers to attract these accounts, rather than trying to win the transactional banking services used by customers, which are more complex to move. However, the survey did not look deeply into what created this expectation of disloyalty.

The fear that customers were going to be disloyal was symptomatic of another effect that established institutions expected to see because of the relatively low cost of new channels – that electronic channels would lead to new entrants coming into the market. In addition there was concern that these institutions would be starting with a lower cost base. In most markets, bar the very concentrated Benelux market, there was a widespread belief that low-cost delivery channels would open up the market to new entrants (Table 5).

Table 5: Low-cost delivery channels and the rising use of advanced customer management/ targeting techniques have enabled many new firms to enter the financial services marketplace (%) (2001)

	UK banks	Benelux banks	French Banks	German banks	Italian banks	All euro zone banks
Agree	84.21	40.00	66.67	100.00	80.00	72.22
Disagree	15.79	60.00	33.33	0.00	20.00	27.78

There was an expectation that the entry into the market of highly entrepreneurial enterprises using new channels would change the way banks competed against each other. The arguments that these channels were lower cost and also allowed banks to target national markets at relatively low cost were a major concern for established banks. It was expected that new banks using new channels would indeed be lower cost and would disrupt the market. This form of new entry had already been seen in the US and to an increasing extent in the UK.

Table 6: Which of the following do you see as the main method of retaining loyalty with customers using electronic channels? (%) (2001)

	UK banks	Benelux banks	French banks	German banks	Italian banks	All euro zone banks
Price	26.32	0.00	0.00	20.00	20.00	11.76
Proactive selling (predictive marketing)	0.00	0.00	33.33	0.00	0.00	5.88
Information-rich services	26.32	50.00	33.33	40.00	0.00	29.41
Transparent workflow	5.26	25.00	0.00	0.00	0.00	5.88
Integrated access to other channels	42.11	25.00	33.33	40.00	80.00	47.06
Alliances with other e-providers	0.00	0.00	0.00	0.00	20.00	5.88
Other	0.00	0.00	0.00	0.00	0.00	0.00

However, that did not mean that banks were interested in a price war with these new entrants – a war that they probably thought they could not win. Instead they wanted a spending war, and to offer a depth of service that would be hard for a new entrant to replicate at a low enough cost. Table 6 shows that the use of information-rich services and integrated multichannel delivery were considered to be the keys to beating the new generation of start-up banks.

Low-cost channel entrants lacked economies of scale and were competing on price. This is an uneasy combination. If the channel itself accounted for the vast majority of costs, and this cost could be slashed by operating without legacy channels such as branches, then new entrants would really have a chance of success. However, if other costs, such as back-office function, treasury management and brand building were also of significance, then such a strategy

was doomed. It is clear that established banks wanted to show the power of their multichannel offering and to offer an array of other services that would be of greater value to customers, thereby dissipating the threat from new entrants. If raw channel delivery costs were not the key battleground, new entrants would be in a difficult situation because they lacked economies of scale elsewhere in the value chain. Equally, if part of that value chain involved the opportunity to speak with an adviser when purchasing a product, this too would undermine the new entrant.

This view may seem complacent. However, later research seems to support the view that multichannel banking is the key to success – even in Internet banking. Research has shown that the banks that are most successful at offering Internet banking services and converting customers to the Internet channel are those that have a comprehensive and advanced branch network (Riquelme and Kam, 2007). Whether by luck or judgment, the complacent view has won the day. Multichannel banking seems to have been a key differentiator between new and old banking firms and most of the dedicated Internet-only banks have fallen by the wayside.

These findings show that the banks at the time of enormous market entry believed, as Porter (2001) outlined, that strategy and barriers to entry were not swept away by new dot.com entrants, but that the Internet may have been simply reinforcing the need for scale and squeezing margins through improved transparency.

3.3. The Fate of Stand-Alone Internet Banks

In broad terms, the Internet-only channel is a niche area of banking. Most banks have adopted a multichannel strategy and few standalone Internet banks still exist. Institutions want customers to use channels to best effect, using face-to-face environments for advice and sales and then managing the services acquired through the automated channels. Even the surviving Internet-only banks are relatively small.

Even many standalone Internet banks, or standalone Internet banking subsidiaries, were looking at other ways of attracting customers beyond offering low costs and home banking through a wire. For ***ifs***' 2001 survey the four standalone institutions interviewed were asked what method they were most relying on to develop greater revenues. Two responded that they were looking at merger to grow the customer base (effectively saying they were willing to be taken over). One was still putting greater emphasis on marketing to gain new customers and the fourth said it was simply a case of improving retention rates to build up revenues in the long run. Thus it can be seen that only one such institution really believed that they could continue to acquire customers in the manner that they once had.

The key example of an Internet-only bank that has generated real scale is ING Direct. It achieves scale on a global basis, but is still relatively small in most of the markets in which it operates (its total assets in its first market, Canada, are still a relatively modest C$23bn – ING Direct History, 2008). In the largest market in which it operates, the USA, ING is by far the largest direct-only bank. It has been a relatively successful business in the UK, but is only the 21st-largest deposit taker (Steen, 2008). While this is a respectable result, the fact is that ING Direct is the only significant Internet-only operator in most of the countries in which it operates, yet is still far smaller than entrenched competition.

The competitive threat of standalone Internet banks and separate Internet-only brands supported by established players fits a long pattern of new threats to the established players. These threats are often built up and 'marketed' by those with a vested interest in creating change, often change driven by technology. Over recent years threats have included:

- telephone banking;
- standalone Internet banking;
- supermarket banking; and
- overseas direct entry.

However, most threats have faded, scale has won, and the good ideas and processes developed and tested by new entrants have simply been incorporated into the channel strategies of the main banking groups.

The market professionals surveyed by the ***ifs***/Chartered Institute of Bankers recognised that, while electronic banking services were expected to create change and introduce new swathes of competition, the outcome was unlikely to be that Internet-only banking would be a long-term threat. Table 7 shows that the vast majority of those interviewed believed that the threat from standalone Internet banks would fade, even if they did believe that margins would be hit by the availability of direct-only models.

Table 7: Do you believe that Internet-only providers in your sector can survive in the long term? (%) (2001)

	UK banks	**Benelux banks**	**French banks**	**German banks**	**Italian Banks**	**All euro zone banks**
Yes	11.11	0.00	66.67	0.00	20.00	16.67
No	88.89	100.00	33.33	100.00	80.00	83.33

It is difficult to know what impact new channels have had on banks. The availability of new channels has certainly changed banking, but whether this is the key factor in squeezing margins seems unlikely.

4. Conclusion

The notion that each new channel will prove to be a disruptive technology/ strategy that will allow new entry into the financial services sector is driven by the concept of channel substitution. The working assumption when studying the cost effectiveness of different channels is that the more the channel is driven by the customer, the lower the marginal cost of serving that customer. By 'driven', we mean that the customer is the one who is inputting transaction information into the system and the administrative function is in part passed to them. However, this innovation is not enough to build an entry strategy into the banking industry – there is clearly more to banking than channels and a new channel alone is not enough to overcome all the other barriers to entering an established market place.

However, there is little room for complacency among banking groups. In related sectors we have seen online, user-driven technologies change the competitive landscape and force established groups to retreat from frontline selling to the parts of the value chain where they still retain some advantage – often scale. General insurance products have a low level of complexity, and the direct-only model has been a significant impact on the industry (Staikouras, 2006). The simplicity of the general insurance product, the need to renew it each year and the very clear cost structures involved have meant that the direct-only model, coupled to aggregation models and price comparison models, have wreaked havoc on the traditional models of delivering these services. The more interwoven relationship between a current/checking account and a customer's life has protected banks from the worst impact of direct-only models. However, new generations of customers and their increasing willingness to use new technologies and business models may undermine the banking industry's inherent protection from new channel entrants, and the return of the threat in the Web 2.0 and 3.0 periods cannot be discounted.

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Appendices

1 – Survey Participants

1999 survey participants

Note – many institutions had multiple responses from different operation units.

- HSBC
- Prudential
- Barclays
- Abbey National
- Clydesdale Bank
- Yorkshire Bank
- National Westminster Bank
- NatWest StreamLine
- NatWest Mortgage Services
- Alliance and Leicester
- Leeds and Holbeck Building Society
- Newcastle Building Society
- Coventry Building Society
- Halifax
- Provident Financial
- Woolwich
- Principality Building Society

- Provident Financial
- Granville Private Bank
- Bank of Ireland
- Industrial Bank of Japan
- HSBC – Midland Investments
- Lloyds TSB
- Cheltenham and Gloucester
- National Bank of Australia
- Countrywide Financial Services
- Latham & Co
- AIB
- LIFFE
- Unity Trust Bank
- Deutsche Bank
- Cigna
- ENBA
- First E.
- Sun Bank
- Charles Schwab
- Virgin Direct
- EGG

2000 survey participants

- Abbey National Plc
- AGF
- Allianz
- Allied Irish Bank
- Aon Corporation
- Arbuthnot Latham
- Bank Julius Baer & Co Ltd
- Bank Of Ireland
- Barclays
- Birmingham Midshires BS
- Bradford & Bingley BS
- British Arab Bank
- Bupa
- CFPL
- Cheltenham & Gloucester
- CIFT
- Clydesdale Bank
- Co-Operative Bank Plc
- Cornhill Insurance
- Dealwise
- DLJ

- Family Assurance Society
- Halifax Plc
- HSBC
- Leeds & Holbeck Building Society
- Lincoln National
- Liverpool Victoria Friendly Society
- Lloyds TSB Group Plc
- Lombard
- Lombard Insurance
- Midland Investments
- National Australia Life
- Nationwide BS
- NatWest
- Newcastle BS
- Norwich & Peterborough BS
- Pet Plan Group Plc
- Principality Building Society
- Prudential Banking/Egg
- Prudential Corporation Plc
- RSC Mortgage Service
- Staffordshire BS
- Sun Bank

- Watson Wyatt
- Yorkshire BS
- Yorkshire Bank

2001 survey participants

- BNP-Paribas
- CCF
- Société Genéral
- Crédit Agricole
- San Paolo IMI
- Banco di Napoli
- Banca Popolare
- Banca Carige
- Cassa di Risparmio di Firenze
- Credit Suisse – Deutsche
- Deutsche Bank
- Bank fur Arbeit und Wirtschaft
- BHF
- Dresdner
- Banque et Caisse D'Epargne de l'état Luxembourg
- ING
- Rabo Bank

- ABN Amro
- Fortis
- Mees Pierson
- Postbanken
- Nordea
- Banco Popular Espanol
- BBVA
- AGF
- CDC
- Swiss Re
- Generali Global
- KBC Insurance
- Allianz
- FBD Insurance
- Bank of Ireland
- Legal and General
- Family Insurance
- Standard Life
- National Australia Life
- Aon
- Royal Liver
- Leeds and Holbeck

- Barclaycard
- Adam and Company
- HSBC
- Royal Bank of Scotland
- Lloyds TSB
- Barclays
- Halifax PLC
- Bank of Scotland
- Abbey National
- Co-operative Bank
- Alliance and Leicester
- Britannia Building Society
- Intelligent Finance
- Post Office Network Banking

2 – ifs School of Finance

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