

Diversification Possibilities for Financial Institutions

By André Babeau

Between a concentration on the profession and total diversification, one perceives nowadays a certain hesitation in the strategies adopted by financial institutions. It is true that the choices in this domain are extremely complex and any error has serious consequences. It is no doubt interesting from the point of view of companies specializing in housing loans to try and draw some inferences from recent evolutions seen in this domain.

It seems to us that these inferences can be grouped around the three or four findings that we will try and develop: Firstly, the advantages of specialization are not being called into question; the arguments that favoured specialization a few decades ago are still relevant today. But it is true that a tendency towards despecialization has appeared, the reasons and modalities of which must be specified. It will be seen then, that this despecialization does in reality have limitations, which owe themselves to the fact that since one cannot practice all aspects of finance at the same time, the reference to one particular function remains indispensable. One will therefore state finally, the conditions which according to us, make for the success of a well-balanced

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diversification emerging from one specific function, that of institutions specializing in housing loans.

1 THE ADVANTAGES OF SPECIALIZATION REMAIN

For over two hundred years, the advantages of specialization have been analyzed in economic literature, under at least two aspects : The rise in productivity which Adam Smith attributes to the division of labour within the enterprise, and the relative advantage in production, which, according to David Ricardo, should serve as a rule in the international specialization of activities.

The "relative advantages" in relation to "multinational banks" are many since it concerns companies specializing in credit.

1.1 The understanding (knowledge) of markets and of the professionals who work in them.

Knowledge / understanding of markets is extremely important in real estate transactions; new markets, old markets and within the latter, the renovation market. Equally important is the understanding of the professionals in these markets, such as the promoters, the real estate agents, the notaries etcetera. Due to a lack of better understanding of these different intervening parties, the analysis of the functioning of these markets remains superficial.

1.2 The understanding (knowledge) of the clientele and its real needs.

Knowing the true needs of potential borrowers is also a relative advantage enjoyed by specialized companies. Borrowers all have different requirements. In a multinational bank, the clientele is sometimes regarded as being homogenous.

For companies specializing in housing loans, the concentration on the "family cell" is a great advantage. It creates an "affective" proximity vis-a-vis the clientele. The evidence of this is quite obvious in the communication developed in many countries. The confidence which characterizes the rapport between the clientele and the lending firm, allows the latter to communicate on subjects like the education of children, the death of one of the partners or even the transfer of estate through inheritance.

1.3 A greater capacity to develop and a better development of a portfolio of services catering to the needs.

Specialized companies are likely to perform better than commercial banks in matters of provision of services. Since the banks offer a large gamut of services, these services are somewhat standardized, and hence less adapted to the different types of clientele. To a certain extent, banks offer the equivalent of ready-made clothes as opposed to those that are made to order.

This difference is even more accentuated if

one takes into account the innovative capacity of specialized companies: being closer to different types of clients, they are able to offer better services to satisfy diverse needs. There is no doubt that in countries like the U.K. and France, the companies specializing in housing loans were pioneers in the field. In France, an organization like the UCB has played an important role in the setting up of insurance services in case of unemployment or of buying in installments. This organization, like the SOVAC, has made innovations in the field of loans at variable rates, particularly in imposing limitations.

1.4 Superior quality in sales and in after-sales service

Lastly, in addition to their network of distribution, made up of highly qualified salesmen, specialized companies are capable of supplying an after-sales service and managing contracts catered to their clients' needs.

Emerging competitive conditions in this field do not threaten the above mentioned specialist organizations, as the possession of their assets is uncontested. In spite of this, the arising conditions prompt the organizations specializing in housing loans to adapt to a certain amount of diversification.

2 TENDENCIES TOWARDS DESPECIALIZATION ARE HOWEVER MANIFEST

The reasons for the appearance of these tendencies in the direction of diversification are well known, but the ways and means of diversification are extremely varied. Let us briefly recall the first few, before describing the others at length.

2.1 Reasons for the despecialization of financial organizations.

The first reason is of course the uncertainty in markets and in different financial aspects, which in the case of Europe is connected to the emergence of a single market.

The uncertainty of markets often facilitates the forming of a new order, bringing together professions which were hitherto considered far removed from each other. With regard to regulations concerning companies specializing in credit, one must mention the Building Societies Act of 1986 in the U.K.. We will come to that later. In Germany, the Bausparkassen have broadened their gamut of services considerably in the direction of savings, by offering new services such as life insurance.

The uncertainty was, in fact, only one of the reasons for despecialization, and did not contribute to it very strongly. The necessity arose due to the existence of competitors and a clientele whose needs had increased immensely.

The increased quality of life of consumers in advanced countries has in the course of the last few decades brought about a diversification in their needs, not only in matters of consumption, but also in the field of investments, debts and financial securities. Private individuals who are clients of financial establishments have themselves acquired a better understanding in matters of choices to be made. They have thus become more exacting and less faithful.

It has been observed in many of our countries that competition has become stiff as a result of the modifications of supply (companies using possibilities brought about by uncertainty) and of the evolution of demand (more complex needs calling for a greater number of services).

In the conditions that one has seen, the fact that very diverse modalities of despecialization have been put forth by financial institutions is not surprising.

2.2 Very diverse modalities of diversification.

In the wake of a demand that has become "global", big companies have often chosen

to present a "global" supply. It is a strategy of "universal finance" that is dear to our German friends (Allfinanz). This strategy has obviously taken different forms, depending on whether the original function was that of a banker, an insurer or a specialized lender.

In the framework of what is called BANCASSURANCE, various European banks have developed insurance activities within their groups which have had to do more with life than with damages. One has far too many choices to quote examples of this form of despecialization undertaken in countries like the U.K., Germany, France or Spain. Life insurance receipts and capitalization gains issued by insurance companies are then distributed by the entire banking network. Besides the objective of the network to make a profit, there appears, on the part of the lenders of banking groups, the desire to totally control the issuing of receipts as well as the management of calculating reserves, to be disbursed in the banking network among clients and others.

Dealing in private property is yet another source of earning extra commission for banks.

For insurance companies the despecialization has become what one calls ASSURFINANCE in France. Insurance companies have spread their activities in the direction of banks. With life insurance services bound to a unit of account (often a part of the investment company), companies had already introduced their clients to the field of unit trust, a field in which they have an obvious expertise; from here it is only a step towards proposing a "unit trust" service to private individuals. In the same way, when the surrender value of certain life policies is not particularly rewarding, the insurer can think it wise to offer certain kinds of loans to his clients, to guarantee their liquidity.

In Germany, for companies specializing in housing loans one could mention the relations established since 1976 between the construction savings bank Wustenrot and

the insurance company Allianz for cross sales of products; in this capacity, for example, Wustenrot has to sell several insurance policies which are drawn up and managed by the group Allianz.

In the U.K., the diversification of activities of Building Societies could alone inspire a special study. For nearly a century they have been dealing with life insurance connected to mortgage loans. They had rapidly begun to sell whole life insurance policies unconnected to loans or damage insurance policies for lodging. But the Building Societies Act of 1986 had obviously contributed to the process of diversification of supply, authorizing not only the sale of all categories of insurance services, but also the investment of non guaranteed loans, the opening of cheque book accounts and the distribution of credit cards.

In the face of such marked tendencies towards despecialization, can one forget the basic function of the company? That would be an exaggeration. For example, Abbey National, a building society turned bank was reminded of its original function (specialization) when it had to make provisions (constitutional) to deal with bad debts in 1990.

In general, with the exception of some very big companies that could perhaps become perfectly polyvalent, there exist obvious limitations to the process of despecialization.

3 DESPECIALIZATION SOON RUNS INTO LIMITATIONS

Certain observations can be drawn from the experiences of despecialization that have just been mentioned. In the first place the difference between planned despecialization and the way it is actually put into practice is not negligible. The general management of estate is a good example. In reality, it is often reduced to the management of just one part of the inheritance (the stocks and shares portfolio). Here is the proof then that even in big companies, competence cannot be taken for granted.

The way in which banks have spread their activities in the field of insurance is also full of lessons. At first only life insurance companies had been set up in banking groups, but not damage insurance companies. This is because management of damages requires specific skills. But within the life insurance companies created by banks one sees the appearance of revealing cracks. Pure risk services (insurance in case of death) continue to be considered external by an insurance company with which one has signed an accord. On the other hand, all services related to the capitalization technique with which a banker is more familiar are formulated by insurance companies.

The reasons for this selective despecialization are not very difficult to find. They stem from what is known as the "ethos" of the enterprise. They also stem from the specific character of the factors of production that are implemented. They can also result from a realistic taking into account of the true needs of the clientele.

3.1 The importance of the ethos of the enterprise

It is not easy to give a simple definition of the "ethos" of an enterprise. Men at work often consciously imbibe this work culture or ethos which in turn is characterized by the function of the organization. For example the work culture of multinational banks is certainly not that of car insurance companies or that of companies specializing in mortgage loans.

In reality, in this domain, the experiences in big establishments seem to proceed more by the juxtaposition of different cultures with reference to diverse fields of finance than to engender a "syncretic" culture which would include all fields. This is a serious limitation to thoughtless strategy of despecialization.

3.2 The nature of the factors of production

In an analytical manner, a function corresponds to, as economists say, a function of production associating two major factors: work and capital.

As far as the work and capital factors go, one would insist above all on the importance of training personnel; it is not always possible to recruit personnel who have the required training. Existing personnel must be given fresh training. This is never simple, but it is easier when one is dealing with younger workers who have a good level of general knowledge.

It is easy to bring out the importance of capital in despecialization. Certain operations are undertaken to extract profits from fixed capital (for example, network of banking agencies). But on the other hand the inadequacy of certain types of equipment (expensive packages of computerized services) constitutes a serious obstacle or leads to peculiar forms of despecialization (such as institution and management of counter services). There would be an obvious difference in the management of loans ranging from 6,000 to 8,000 francs, and those that fall in the range of 40,000 to 50,000 francs.

3.3 Taking into account the real needs expressed by the clientele.

Insofar as the consumers (savers) are concerned, it is not sure that the demand for financial services is as global as one makes it out to be. The typologies of the existing clientele often reflect contrasting attitudes. Some prefer to have an entire gamut of services at their disposal in one single company, while others are of the opposite point of view. Often it is for reasons of discretion that they prefer to deal with different companies for the different components of their inheritance, but often it is because they understand the merits of specialization.

One understands, then, that to succeed, despecialization in a mortgage loan com-

pany should be selective and should fulfill certain conditions.

4 CONDITIONS FOR SELECTIVE DESPECIALIZATION

There are four conditions; proximity to the original function, simplicity of the services of diversification, mastery of the conception and itemization of these services and lastly the formation of a service network.

4.1 Diversification closely related to the original function

It is in the needs expressed by the consumer (saver) that the proximity to the original function should exist. So, for example, there exists some logic in the sale of optional services by insurance companies as well as by pension funds because these appear within the establishment or in relation to a private individual as complimentary to the statutory old age protection services.

For mortgage loan companies, it is undoubtedly in the family cell and perhaps in real estate inheritance that these complementarities could arise. So the sequence accommodation loan, the whole life insurance and invalidity of mortgage loans and accommodation risk indemnity insurance appears quite natural; the reference to the family cell could prolong this sequence towards insurance for the education of children and for unemployment; the reference to real estate could lead to an offer for its management, which could become frighteningly complex.

In France, an organization like the SOVAC had wished to increase its offer in the gamut of debt services, especially within its real estate account which allows insolvency in a current account. The residual is transformed into bills of fixed sum at a fixed rate in the latter period.

One has already mentioned the role of an organization like the UCB in matters concerning unemployment protection of the lender. The La Henin bank has been proposing a multi-risk accommodation insur-

ance managed by the Groupe Victoire for some years now. As for the Credit Foncier, it has recently started an activity which allows it to propose investment services like SICAV, common funds for investment or civil societies for real estate investment (SCPI) to its clients. We shall come back to the management of inheritance.

All these are diversifications of activities which follow a certain logic of proximity to the original function.

In this new offer, there is obviously a time lag to be respected. Certain services should be proposed right from the subscription of the loan (various insurance services), others a few years later (for example personal loans for supplementary work) and yet others at the end of the reimbursement (investment services).

4.2 Choice of simple services

A specialized company should be able to propose elaborate services to its important customers. In the same way, for diversified services, it should remain close to simple concepts. Comparisons between banks and insurance give interesting examples in this field. In the Netherlands, since the merger between National Nederlanden (Natned) and NMB Bank, the latter sells only simple insurance services, leaving to the network of traditional agents of Natned, the responsibility of selling contracts that are more personalized and therefore more complex.

The main argument in favour of relatively simple diversification services is that these services will be sold by persons who will not necessarily be specialists. Of course, they would have undergone adequate training, but that will not put them on par with professionals who have been in the trade for decades. The simplicity of the offered services will therefore allow sellers to enjoy a certain credibility because they will have a perfect knowledge of the services.

4.3 The mastery of the conception of "itemization" of services.

The formulation of services of diversification could well be the subject of partnership accords with external organizations. But the specialized company should maintain a mastery over the conception of the service and this in turn should be the subject of "itemization" which connects it explicitly to the gamut of services sold by the specialized company.

The need for the mastery of the conception explains itself well: If it is necessary that the service be simple, for reasons already mentioned, it is also necessary that it corresponds to the needs of the clientele; so the specialized company alone knows its clientele well enough to define the services that it needs.

The "itemization" form of the service asserts itself on the one hand from the point of view of the clients so as to not confuse the image of the institution in their eyes by a reference to the external organization, and on the other hand dealing with size of sale, to obtain an appropriation of the service and thereby a stronger motivation for the sellers.

4.4 Assistance

The fourth element of successful despecialization corresponds to the placing of services sold by the specialized company, services that form an important aid to clients in the decisions that they must take.

It can firstly be about information, for example, on diverse real estate markets. For revenue-earning property, one can easily see what certain "packages", which include the placing of a loan, the help in choosing a programme and eventually the rental management itself are.

Another sector where services could be useful is the management of inheritance. In France, since 1983, the La Henin Bank has developed a service of estate advice which supplies, among other things, an expertise

DESPECIALIZATION . . .

⇒ 29

in matters of succession or at the moment of declaration to the solidarity tax on wealth (ISF). There is simply no doubt that the offer of such services contributes efficiently to the faithfulness of diverse groups of clients.

Thus, if specialized companies are pushed towards a certain diversification of their offer, by the uncertainty of markets, by the evolution of demand, by the stiffening of competition, this diversification should obey certain rules. Among these, the permanent reference to the original function, to the know-how which characterizes it, to the understanding of the clientele that it implies, appears to be the most important. It is from the original function that the "logic" of diversification should develop. To forget this elementary rule would risk arriving at dangerous decisions, which could generate severe disillusionment. ■

DOCUMENT . . .

⇒ 31

the Secretariat will be established through redeployment within existing resources. The preparatory process and the Conference itself are to be funded through existing UN budgetary resources, and through voluntary contributions to a trust fund established specifically for the Conference. A separate voluntary fund will be established for the purpose of supporting the participation of developing countries in the conference and its preparatory process. Any cost-benefit analysis of the resources to be used for the Conference over the next three years will therefore be difficult. More productive options for the use of such resources remain to be explored.

While the new UNGA Resolution to convoke a Habitat II reflects no new concepts or ideas that have not been preciously expressed in UN resolutions of the past, it does recognize that "human settlements" did emerge from the Rio Conference as a sector much in need of funding and devel-

opment. The Agenda 21 plan of action from the Rio Conference does contain a laundry-list chapter outline of eight major programs to be financed in part through investments of the countries themselves but with significant international essential additives. To some extent, the Habitat II will need to address with realism the inadequate programs of the Agenda 21 Chapter. But this is a task also for the existing Commission on Human Settlements which will meet next in Nairobi in April 1993. The Commission should give special emphasis to the subject of mobilizing household savings and the relationship of housing finance programs and sustainable development for all sectors of the population. Perhaps in this way it can provoke discussion of existing UN instruments such as the Habitat and Human Settlements Foundation presently operating under Habitat and whether or not it is fulfilling the mission defined by the UNGA resolution of twenty years ago.

UN resolutions, conferences and plans of action will undoubtedly continue to proliferate through the present decade. But it is important for all concerned with the emerging new world order that the verbiage and phraseology of these international events be based on real scenarios from which will emerge strong constituencies and visible action on the ground to meet the expressed needs. "Global Strategies" may too easily become elaborate charades or masking the lack of will or interest on the part of governments and others to face up to the urgent requirements to mobilize and to help people help themselves when it comes to shelter and improvement of community environment. ■