



The entry barrier is collapsing, what to do next?

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Jianmang Li studied theoretical physics in university when he was 13. He had spend 13 years in nuclear energy research field. Last year he went back to university for a MBA degree. Currently he is doing a project in [ABN-AMRO Bank](#) for his MBA thesis. The subject of the project is the strategic issues of Internet banking.

Michael E. Porter, the prominent figure in the business strategy field, suggested that there are five competitive forces that tend to drive down the profitability of an industry. One of these forces is the threats of new entry. New entrants bring new capacities into the industry which in turn drive down the profitability of the industry. In order to protect their long term profitability, the industry incumbents have to build up entry barriers. Without entry barriers, no industry can earn sustainable high returns.

What is the current entry barrier of retail banking? Is it the economies of scale? There is no enough evidence to support that large banks enjoy cost advantages over small ones. Look at the annual reports of three major Dutch banks ([ABN-AMRO](#): \$300 billion balance sheet assets, [ING Bank](#): \$150 billion and [Rabobank](#): \$160 billion), the major costs are stuff costs which are the direct variable costs. The depreciation charge of fixed assets, which is the major source of economies of scale, is only around 7% of the total costs in all three banks. Is it the product differentiation? The answer is no. Most of the products sold in retail banking are as old as the industry. No much room is left to differentiate those commodity type of products. Is it the government regulation? Partly true, but that barrier had been lowered considerable during 80s banking deregulation in all industrialized countries. Is it the banking know-how? Partly true, however this barrier is not very high. Is it the brand name? Yes, it is the only significant entry barrier of retail banking.

How do banks managed to build their brand names while the products they sold are commodities? The magic lays on the customer services. By far the most important customer services in retail banking is the payment services. So the payment service delivery channels are always the important issues on retail banking. Any changes regarding to the payment system and service delivery channels will have profound impacts on this industry.

In the old days, the only payment services delivery channel was the branch network. This channel has two characters; expensive and exclusive. It is expensive to set up a branch network. Once set up, the same physical locations can not be used by others. These two characters make up the basic contents of the entry barriers of the retail banking. To prove the argument, let's look at the history. In history, only one industry had made a successful entry to retail banking. It was the Postbanks from PTTs. This entry story had been replicated in many countries. The simple reason is that the PTT companies have their nation wide branch offices. Nowadays, supermarket giants also found that this entry barrier becomes particular low to them because their stores are even better positioned then bank branches. So we saw supermarket giants in UK started to enter retail banking.

These two characters are not exist in Internet banking. With \$2 million, one can set up a full function Internet-only bank and provide payment services on the Internet. The physical location does not mean anything on the Internet. So the traditional barriers of retail banking do no exist in the Internet banking. Without any barriers, we will see a host of Internet-only banks enter into the industry. At this moment they do not pose an immediate threat to existing banks. However the threats will become larger and larger when the transaction volume on the Internet market take-off.

We can think the entry barrier as a dam and the water hold upstream is the profit of the industry. One factor that

determine how much water can be hold is the height of the dam. For retail banking, the height of the dam is measured by amount of investment and exclusiveness of the service delivery channels. Internet banking is starting to drill holes on the foundation of the dam. This holes will only cause minor leakage at beginning. The leakage will become larger and larger. The whole dam will collapse when leakage developed into current. The water stored upstream will flow out in no time. Using Internet as addition delivery channel, as many banks perceived the usage of the Internet, is like help those Internet-only banks drilling holes on the dam. It makes no sense for an existing bank to do that unless it is sure that the water flow out of the collapsing dam will be restored in its own lake where it has already build anther dam at downstream.

For bankers, the strategic issue is not how to integrate the Internet banking into their portfolio of existing delivery channels. The important issue is how and where to build a new barrier before the old one completely collapse.

How could one build barriers on the Internet while it is supposed to be open? I don't know whether I can offer an answer, however we all can discuss this issue. Let's first ask ourselves; Why majority of the Internet users do not use Internet banking? It is easy to blame the customer inertia or perceived security problem. What about the slowness of the Internet? [GVU Internet User Survey](#) has consistently shown that the slowness was and still is the number one problem of the Internet. My personal experience tells me it is true. Each time when my telephone connection to my Internet Service Provider (ISP) pass half hour, I start nervous because I know that my telephone bill next month will be high again. Under such a pressure, I can be easily annoyed by the slowness of some sites. As we all know, business is to seek unsatisfied customers needs. If there are unhappy customers then it means business opportunity. What does the slowness of Internet means to banks? It means banks can speed up their service by using Intranet or Extranet to bypass the public traffic. It means banks can reduce the number of gateways between customer and point of transaction by setting their Internet web server right at the customer entry point (ISP) and organize Internet market there. It means that banks can reduce customer nervousness by charging businesses instead of customers for the Internet market entry fees.

No industry can afford to have no entry barrier for a long period of time. Some one is going to build it up. Those existing banks that regard Internet is just another channel will probably miss the chance to set up the new barrier on Internet. If the old barriers completely collapse and the new barrier has already been set up by early movers then these banks will be in big trouble.

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