

# The Deeper Threat From E-Commerce<sup>1</sup>

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“The Impact of E-Commerce on . . . [fill in the individual market of your choice]” could be the keynote speech at any securities industry conference. “How E-Commerce Changes Everything” shows up less frequently on today’s agendas. But I believe that the latter title will prove to be an accurate prediction, as expanding on-line competition forces fundamental structural change in the business models underlying the securities industry.

In considering the long-term consequences of e-commerce for financial services firms, an unsettling analogy can be drawn with the computer industry of the early 70s. Before the PC, a handful of powerhouses, whose concentration was growing via mergers and acquisitions, dominated the industry. High profit margins in areas such as mainframe hardware subsidized losing businesses such as software. Proprietary designs and contractual terms locked customers into vendors via high switching costs. As in investment banking, offering a full line of services to maintain client relationships was viewed as a key to success.

Major computer firms initially viewed the PC as creating challenging but manageable competition within individual markets and ignored the larger strategic implications. Over time, however, the inexorable growth of the new technology spread to challenge all of the incumbent markets causing a complete restructuring of the industry. Of the computer firms prominent at that time, only IBM remains a power — and that required a dramatic eleventh-hour restructuring by Lou Gerstner.

Today’s securities industry shares many characteristics with the computer industry of the 70s. A core group of global firms consistently lead the league tables in most major markets. These firms deliver products and services through collections of business units that operate independently with their own distinct P&Ls. Some extremely profitable units subsidize their less profitable brethren, whose presence is nonetheless considered necessary to be a top competitor.

This core group is surrounded by national and niche firms similar to the smaller computer systems service firms that served local clients or offered specialized

services. These firms rely on their specialized relationships and contacts to create profitable, focused businesses offering tailored products and services that aren’t easily matched by larger firms.

Just as PCs transformed the computer industry, the growth and commercialization of e-commerce over the past decade have unleashed forces that challenge both securities industry business models. Today’s forces largely result from four basic characteristics of e-commerce:

- the ability to deliver unprecedented levels of tailored services at declining prices (causing customers to expect such changes),
- the increased pricing transparency of most on-line services coupled with reduced barriers to switching firms (eroding customer loyalty),
- the creation of new opportunities for automation and electronic linkages (further reducing costs and increasing service expectations), and
- the growth of open standards, alliances and new business models (fragmenting and redefining business value chains).

Against this background, what sort of restructuring of the securities industry is likely? We can find important clues by examining three major categories of e-commerce-driven change: organizational restructuring to meet competition, adding and subtracting links in the value chain, and leveraging back office capabilities. These clues are evidence that the revolution is just beginning.

## Structural Changes to Meet New Competition

The entry of a new, significantly more efficient challenger like the PC can force significant structural changes in a market. In the securities industry, look at the response of the exchanges to the ECNs. In the U.S., the proliferation of ECNs began when the SEC changed its regulations to foster increased competition with the market makers. As a result, ECNs accounted for about one-third of the trade

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volume on Nasdaq by the end of last year. The NYSE specialist firms are likely to be challenged by the ECNs as a result of the repeal of Rule 390, which restricts non-exchange trading in the majority of the most liquid NYSE stocks. Meanwhile, similar insurrections are occurring in other markets.

Because ECNs are a threat not only to the power of exchanges but also to the market makers by whom they are generally controlled, it is difficult for the exchanges to respond aggressively. But with transaction costs for ECNs as low as one-twentieth of those of the exchanges, an aggressive response is required.

The London Stock Exchange recently demutualized to gain flexibility and raise capital for systems upgrades. The Nasdaq, New York Stock Exchange, and Deutsche Börse among others have announced plans to follow this lead. To meet the service offerings of the ECNs, Nasdaq has extended its trading hours and announced new systems initiatives like its exclusive licensing agreement with Optimark. In frequent announcements, other exchanges have been embracing similar changes.

Exchanges are also seeking efficiency through consolidating markets via mergers, alliances and international expansion. A recent example is the announcement of the Euronext Exchange to be formed by merging several European exchanges. Nasdaq is developing a competing European exchange along with another in Japan, and is even discussing a possible merger with the NYSE.

Given their politics, however, it is unclear which exchanges will respond quickly enough. What is clear is that dramatic change is on the horizon for some players that seemed stable only a few years ago.

Wherever new competition enjoys major advantages, deep structural changes like these are likely to occur. Such changes have distinct characteristics:

- they are organizationally and politically difficult to implement,
- they decrease operating expenses over time,
- they compress margins as competition intensifies, and
- they yield survivors that tend to become commodity businesses generating at best normal economic rates of return.

Full service retail brokerage and institutional sales are examples of other markets under challenge by new entrants with similar cost advantages.

## Rattling the Value Chain

In other industries, e-commerce developments have led to traditional value chain activities being redefined by portals, aggregators and service delivery engines. The capital markets distribution network is no exception.

E-commerce provides numerous opportunities for disintermediation. For example, debt issuers are placing their securities directly. The World Bank and Fannie Mae recently sold bonds on-line, and Pittsburgh issued municipal bonds directly over the Internet. Similarly, on-line IPOs by firms like Wit Capital disintermediate the syndicates and retail channels used to place most issues.

The opposite result, intermediation, occurs where a new role is created in the value chain. This often isolates an existing service provider from its clients. For example, Marketaxess is an on-line bond trading platform that plays the role of an ECN in a market where there are no exchanges to displace.

The creation of a portal also results in intermediation. CyberCorp and Tradescape are financial services portals that tap into Nasdaq to find the best price for a trade. By invading an existing value chain, they also sever the links between their clients and the exchanges and ECNs.

Value chain redefinition allows new entrants to grow rapidly by exploiting new business models that tap markets in ways that current firms don't address. Existing businesses can quickly become obsolete. Because entry can be so rapid, however, these markets also tend to have low barriers to entry and hence also yield only normal rates of return.

Similar but broader threats face the retail firms from the financial service portals offered by Yahoo, Quicken and Microsoft.

## Leveraging Back Office Capabilities

E-commerce also increases pressures for change in the back office. Some pressures result directly from the growing use of the Internet by clients and retail customers. For example, the higher trading volumes from Internet investing, especially by day traders, increase operating costs and operational risk. As clients use the Internet platform, they demand new services such as on-line real-time reporting and electronic interfaces.

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Other pressures for change arise indirectly. For example, clients able to get real-time bank and vendor information on a 24x7 basis expect similar services from the securities industry. Institutional clients will not accept excuses when connectivity is readily available, interfaces are being standardized, and key institutions (such as the exchanges) are showing a new-found willingness to change when threatened by new competitors.

Continuous pressure from institutional investors also has driven standardization. Fidelity pioneered, and the buy-side institutions demanded, the adoption of the FIX protocol. Today, they continue to push for added portability through the adoption of the FIXML extensions.

In general, the investment banks have responded to this pressure by increasing automation of their back office processes.

In process intensive areas, new or enhanced services are likely to be high fixed / low variable cost businesses, for which a large market share is critical to success. Over time, these markets are likely to become highly concentrated. High entry costs will permit successful businesses to earn advantageous rates of return. Where opportunities to add value remain, however, industry standard interfaces will require nimble leaders to compete with fast-moving niche services.

In addition to clearance and settlement, trust services and cash management fit this profile.

## Conclusion

The threat posed by e-commerce won't diminish. In fact, it is likely to intensify since the well-funded network economy ensures a series of new entrants able to use the Internet aggressively to offer products and services, or at least to create new distribution channels, wherever opportunity exists.

A few securities markets, like mergers and acquisitions, may escape major changes from automation. Most, however, will eventually be transformed.

Where it eliminates profitable market inefficiencies, e-commerce will also eliminate opportunities for cross subsidizing less profitable areas within the larger firms. As a result, each business unit will be held more rigorously to achieving target rates of return. This will often require fundamentally altering the way they do business.

At the corporate level, firms will need to focus on those products and services where they are likely to have the greatest advantage and to consider exiting those where they are disadvantaged. Moreover, this will need to be an ongoing exercise; constant vigilance will be required as new developments will continue to shift relative advantage among the major firms.

For current niche firms, the ability of larger players and new entrants to match their specialized products or services via technology may eliminate the advantage they enjoy in their markets. Highly specialized and inflexible firms may have no choice but to sell out or merge before they are displaced. Others will be able to adapt or will seek out new markets.

As in computers, new firms, such as portals, aggregators and customizers, will arise to create new niches in which the core firms may play at most minor roles. Some of these niches will grow to become key securities industry segments.

Applied across the industry, these trends will lead to higher levels of horizontal concentration in an industry of less vertically integrated, more specialized firms. Among these will be some mix of traditional firms that have redefined themselves in the new environment and new entrants that have grown rapidly and diversified to become major competitors. Due to their focus on areas of competitive strength, the core firms are likely to be less uniform than today's major firms making the industry less stable as more diverse firms struggle for advantage. Competition is also likely to be spurred as today's profit margins are eroded by the transformation of most markets under the pressure of e-commerce.

The computer industry analogy serves as a cautionary tale in light of current securities industry developments. The moral of that tale is to undertake broad, proactive change before your core markets are affected. To succeed, these changes may need to redefine your businesses as dramatically as the shift from products to services redefined IBM.

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