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Convergence in Financial Services: Paradigm Shift in Business Models

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Abstract: **In the last quarter century financial service sector undergone revolutionary changes due to global economic and competitive forces, which compelled the industry to reshape its products and re-engineer its business models. The changes in regulatory mechanism and liberalizing of governmental policies allowed the banking companies to enter into the securities and insurance markets and to offer services of Insurance and Securities with combination of basic banking products. On the other side securities firms and insurance companies have bounded into the banking business, offering deposit-like products along with basic risk coverage which lead to convergence in financial services. The present article throws a light on evolution of convergence in financial sector, factors of financial service convergence, drivers of convergence and proposes models of convergence with respect to banking, insurance and securities etc.**

Key Words: **Convergence, Financial Services Convergence, Levels of Convergence, Models of Convergence, Convergence Matrix.**

1. INTRODUCTION

The present global financial service sector is experiencing rapid changes in the way of its modes of operations and in its array of offerings. In the last quarter century financial service sector undergone revolutionary changes due to global economic and competitive forces, which compelled the industry to reshape its products and re-engineer its business models.

The traditional basic financial products like Banking, Insurance, mutual funds and securities etc.; were started its meta- markets in the early stages of globalization for mutual benefits. Gradually this meta- market operations of financial service sector companies discovered an opportunity with an advent of globalization of markets and liberalization of government regulations to enter into other basic financial products/services enabling them to create hybrid financial product/ service.

The changes in regulatory mechanism and liberalizing of governmental policies allowed the banking companies to enter into the securities and insurance markets and to offer services of Insurance and Securities with combination of basic banking products. In the other side securities firms and insurance companies have bounded into the banking business, offering deposit-like products along with basic risk coverage. Insurance, mutual fund industry and securities sector moved further in offering hybrid products of securities combined with insurance and investment options like ULIP (Unit Linked Insurance Policy).

The present article throws a light on evolution of financial sector, factors of financial service convergence, drivers of convergence and proposes models of convergence with respect to banking, insurance and securities etc.

BACK DROP:

The financial service sector comprises of banking, insurance, brokerage firms, consumer finance companies and investment companies etc.; which offer financial products to consumers and businesses. The Indian finance code (2013) defines financial products as: (*a*) securities; (*b*) contracts of insurance; (*c*) deposits; (*d*) credit arrangements; (*e*) retirement benefit plans; (*f*) small savings instruments; (*g*) foreign currency contracts other than contracts to exchange one currency (whether Indian or not) for another that are to be settled immediately; and (*h*) any other instrument that may be prescribed under section 150(*1*).

Generally financial services sector encompasses a variety of businesses that deal with financial product management. These include many different kinds of organizations such as banks, investment companies, credit card companies, insurance companies and even government programs like pension funds etc.

2. THE CONVERGENCE:

In this context, convergence of industry which can be defined as the “converging of two or several hitherto separate industries”. In general terms, convergence of industries means two or more industries which offer different products in different market segments merge together. The convergence makes existing industry boundaries, market segments blur/overlapping and push the business to create and redefine new kind of products and product categories.

Convergence is happening in all its forms, which is changing the nature of market structures, demand, competition, competitors and business models and the ways of doing business. Any organization that is not cognizant of this, and does not transform their businesses will be adversely affected.

Characteristics of convergence are:

1. Convergence affects not just only limited to product/service categories. The scope of convergence is the entire business process and transaction-intensive services sector;

2. Convergence is structural in nature, and changes to industry structure are the most profound changes associated with it; and
3. Convergence is enabled by technological change, but is not driven by it. The drivers of convergence are mainly commercial.

Types of the Financial Services Convergence

There are various ways to achieve the financial services convergence. The basic convergence that taking place in banking, insurance and securities etc. products/services can be broadly classified into two categories via substitute convergence and supplement convergence.

The substitute convergence is sharing commonalities such as the similar product characteristics, functions or some other element, while the second category supplement convergence means two or more united products that are better designed than before.

In terms of the extent of the industry convergence, there are overall convergence and partial convergence. In the former, it is a whole new industry integrated by two or more industries; latter is just with some sections of the industry getting converged. Therefore, the financial industry convergence can be divided in four kinds: penetration convergence, crossing convergence, reorganizing convergence and substitute convergence.

1.Penetration convergence. The penetration convergence takes place between traditional financial services and modern/ sophisticated financial service. The introduction of information technology in banking sector, the services like cash withdrawals and deposits from ATM made easy by saving time of customers and bankers, and enabled the bankers to extend its basic services to remote areas without opening of branches there.

2. Crossing convergence. It is a function supplement and extension. It creates a converged new industry system by gaining a stronger competitiveness with new technology. Crossing convergence is usually partial integration with the existing of the original industry. For example, the crossing cases among banking, telecommunication, and Internet etc.;created new banking services like Mobile banking, credit cards and credit insurance etc.

3. Reorganizing convergence. It normally occurs among industries which are very close to each other, such as a converged business with banking, insurance and securities etc. in this case, it improves the competitiveness of the financial services sector by offering various financial products and services that are different from the old ones. Let for example D-mat accounts, ULIP policies and saving bank account with insurance.

4. Substitute convergence. Industrial convergence is not only a simple stack of a few industries, but an integration of the new industries and traditional industries. Although banking, NBFC (Non-Banking Financial Companies), insurance, securities are different financial services offering different financial products and services, they share some functional commonalities and features. Technology, Digitalization, liberalized policies and internet services provide the standard element and sets for the potential substitute convergence. It is an obvious challenge to the traditional business models of financial service firms.

3. NEED FOR CONVERGENCE:

The convergence revolution has resulted in the emergence of numerous cross-industry products in response to demands by customers for greater diversity of product features, cost flexibility, and efficiency in the delivery of products. Convergence has been driven by the customer expectations, quest for synergies, economies of scale and competitive position in an intensely competitive marketplace. The customers of the insurance products are both the customers of the risk protection and the investment products. That leads to the insurance sector competing with the other avenues of the investment including banks, financial institutions and investment companies. The security broking firms are exploring investment opportunities in all kinds of financial products like insurance, banking, mutual funds and other financial services. Broking firms of today is not only broking firms in its business models but one stop shop offering all the products ranging from commodities to securities, to currencies under one roof.

1. **Heightened Needs of Customers:**

Banks, securities firms and insurance companies each serve financial needs that are different but at the same time complementary. Each is in the business of collecting money and redistributing it within the economy more ever they serve the same customers. Individual customer needs a checking account, credit cards, a mortgage, automobile, home loan and home insurance, financial advice, and a place to invest retirement benefits and savings. A business concern needs a business checking account, business credit cards, commercial financing and credit facilities, plant and equipment insurance, liability insurance, employee health and disability insurance, payroll and other back office assistance, and, if it is sufficiently large, a means of issuing commercial paper and debt or equity securities.

The ability of a single financial institution to offer all of these products offers enormous operating efficiencies, customer convenience and opportunities to enhance shareholder value.

2. **Intensified Competition**:

Increased competition in the banking and insurance sector compelled them to promote efficiency in the allocation of resources, strengthen their flexibility during financial crises, and foster banks and insurance companies to focus on its own competence, thereby putting a premium on financial innovation and diversification. It is also important for the banks to mold a competitive strategy, and to examine and understand the nature of its products and the needs of its customers. To meet the variety of needs of customer financial service firms began to offer converged hybrid products with differentiation and focused strategy to compete effectively in the segments.

3. Innovation and Diversification:

In the last quarter century the financial service markets reached the saturation stage in traditional services. The banking and insurance companies along with securities firms pushed to come out with innovative products or to diversify their operations into other related financial services by implementation of a new product, new service, new organizational form, or new processes that can effectively reduce costs or risks or that improves quality that better satisfy the market participants' demand.

4. REVIEW OF LITERATURE:

Rumelt published one of the most influential books in 1974, "Strategy, structure and economic performance". In this book, Rumelt showed that related diversifiers outperformed unrelated diversifiers. That is, diversifiers who concentrated on some central skills or competencies outperformed all other categories of firms (i.e. specialized firms, unrelated diversifiers, vertically-integrated firms). The use of alternative approaches for measuring diversity has not led to greater insights into the impact of diversification on performance. The results of most studies have merely extended or marginally modified Rumelt's (1974) original findings.

Ramanujan and varadarajan (1989) studied the degree of integration in light of relatedness. Degree of relatedness which indicates how related the new business is compared to the existing business. If the new business is related to existing one istermed as related diversification. If the different businesses have no marketing or other forms of relatedness, the diversification is labelled unrelated. The common idea is that related diversifiers should outperform unrelated diversifiers because they have more opportunities to exploit synergies. The empirical results have not always confirmed this hypothesis.

The research conducted on bank and insurance integration (e.g. Lafferty Business Research, 1991 and 1994; Hoschka, 1994) have classified based on the entry strategies of banks into the insurance industry (i.e. the mode of diversification). The same methodology can also applied to insurance companies entering the banking industry. A distinction was made between de novo entry (start-ups), mergers and acquisitions, joint ventures and distribution alliances.

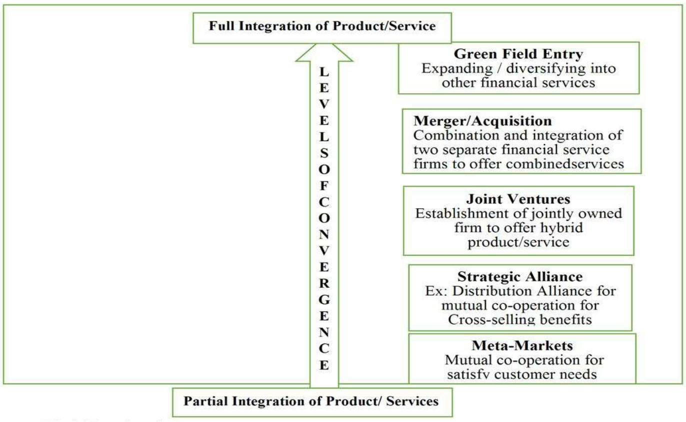
The studies conducted in USA and Europe [e.g. the LOMA study, 1997] define bancassurance as the sale of insurance - manufactured by the bank's own insurance company- through the bank's distribution channels. In such a definition, the researchers explicitly exclude those cases in which joint ventures or distribution agreements are the approach used. This alternative was popular in the beginning but in the last couple of years, mergers and acquisitions have been used more frequently in the financial services industry.

The conglomerate diversification strategies include a category for which there are no obvious technological or marketing synergies, or cross-selling opportunities. This strategy of the 1960s became well known, and is still often arise in the literature (Porter, 1985).

Hill and Jones (1989), however, argued that unrelated diversification can bring greater benefit than the related, as the latter increases the organizing difficulties. The diversification strategy is a tool for mergers and acquisitions initiative.

5. LEVELS OF CONVERGENCE:

Convergence in financial services has been taking at various levels in variety of forms. Hybrid or converged products and services offered in the sector are outcome of level of integration and convergence that happened between in different services in the given time frame in concerned sectors. The levels of convergence may start from mere Meta-Market operations between service firms to a complete diversification of a firm into other financial services for full integration and perfect convergence. This article develops a model for phases of financial services towards levels of convergence and has been presented in the following diagram.


Full Integration of Product/Service
LEVELS OF CONVERGENCE
Green Field Entry
Expanding / diversifying into other financial services
Merger/Acquisition
Combination and integration of two separate financial service firms to offer combinedservices
Joint Ventures
Establishment of jointly owned firm to offer hybrid product/service
Strategic Alliance
Ex: Distribution Alliance for mutual co-operation for Cross-selling benefits
Meta-Markets
Mutual co-operation for satisfv customer needs
Partial Integration of Product/ Services

Source: Model is authors' own construct.

1. Meta-Markets:

Two or more distinct markets that are associated in some way to a product or service is called meta-markets. For example, the meta-market for financial products includes a banking customer may need insurance policy for risk coverage and may also require investment advice to where to invest. So in the initial days of convergence the financial services companies were co-operating with each other to fulfill the customer needs by extending the co-ordination with other kind of financial service provider.

2. Strategic Alliance:

Strategic Allianceis a relation or union between two more business entities where the complementary strengths create more value for the customer than derived independently. Most of the strategic alliances in financial sectors are distribution alliances which facilitates the companies to expand it markets in domestic as well as internationally. Most of the insurance companies followed this strategy with local banks to expand its markets. The strategic alliance facilitates the alliance partner to cross- sell partner's service for the agreed fee or margins. Strategic alliances of the competing banks on the ATM infrastructure is a live example of this.

3. **Joint Ventures:**

The banking and insurance companies moved further from strategic alliance and forming joint venture to offer "Banc assurance" products. The joint ventures between multi-national insurance and banking companies with domestic banks and insurance companies are quite common in developing markets. The joint venture enabled the firms to exchange and co-operate with their expertise to innovate and converge new kind of hybrid product/service to expand into new markets and increase the margins of business. A joint ventures considered to be a more formalized way of co-operation. It is commonly accepted that joint ventures are rather short-term solutions because majority of joint ventures in banking and insurance will ends up in sale. Nevertheless this was a frequently used entry vehicle, especially in cross-border alliances.

4. **Mergers/Acquisitions**

Mergers/Acquisitions are combination and integration of two separate financial service firms to offer combined services. This is recent form of convergence in insurance and banking sector, the big firms in these sectors are acquiring /merging small firms to get synergetic benefits. The merger and acquisitions facilitates the firms have complete managerial control over other firm , so that innovating new kind of financial product in converged form will be easy for them. Merger and acquisition will give one shop stop solution are umbrella offering under one roof for customer, and the firm can reduce the cost of offering and customer can benefit by time and price.

5. **Green Field Entry**

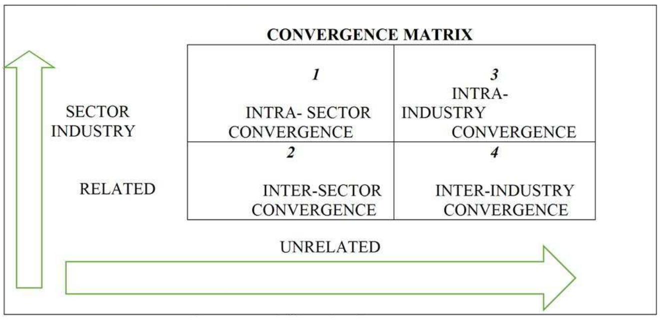
Expanding / diversifying into other financial services is known as green field entry. The most of the banks are expanding their business into insurance and securities by establishing new companies in insurance and other financial services. MNC's of insurance sector also entering into developing countries in banking and other financial services by green filed strategy. This method is highest form of integration and convergence by which companies can effectively deliver innovative financial solution in the form of hybrid/converged service/product.

6. MODELS OF CONVERGENCE: CONVERGENCE MATRIX

The convergence in financial services sector is typical in nature. The evolution of convergence and its possible direction in the future has to be understand to craft strategies effectively, for this purpose this paper attempt to develop a model of financial convergence and interpret this model with a 2X2 convergence matrix. The matrix measures the convergence based on two key variables:

i) **Degree of Relatedness**
ii) **Degree of Service Diversity**

The horizontal axis represents Degree of service diversity which comprises of whether the convergence is within and between same sectors or with other industries. The vertical axis represent Degree of relatedness with two dimensions of whether the convergence of service is taking place in related areas of business operations or unrelated to that particular financial service.


CONVERGENCE MATRIX
SECTOR
INDUSTRY
RELATED
1
INTRA- SECTOR CONVERGENCE
3
INTRA- INDUSTRY CONVERGENCE
2
INTER-SECTOR CONVERGENCE
4
INTER-INDUSTRY CONVERGENCE
UNRELATED

Source: Model is authors' own construct.

1. **Intra- Sector Convergence(Product Convergence):**
The intra-sector convergence can be defined as combining two are more products in a bundle of offer of the same sector. This type of convergence is merely confined to combination of products in the same sector. Some times this combination may develop hybrid financial service replacing the traditional product/service within in the same sector which possess some kind of relatedness in features, process, markets or delivery mechanism. Intra-sector convergence generally happen within same sector value chain by vertical integration of products /services within same chains. The Sweep accounts in banking, pension schemes associated with risk policies offered by insurance companies, and mutual funds with investment options (Debt funds vs Equity Funds, Combinations of both) are some hybrid products of intra- sector convergence.

2. **Inter- Sector Convergence(Sector Convergence) :**
The inter-sector convergence takes place when two are more financial services integrate together to offer new kind of product or hybrid product. This type of convergence is generally needs higher level of integration than intra-sector convergence as the converged product is outcome of two or more financial services whose value chains are different from one another. The convergence between banking and insurance sectors, banking and securities sectors, insurance and securities sectors falls under this category. Majority of financial services convergence of recent times belongs to inter-sector convergence. The bancassurence which is convergence of bank and insurance, securitization or asset securitization a combination of bank and security service, unit linked insurance policies (ULIP) is a integration of insurance and mutual funds are name a few.

3. **Intra- Industry Convergence(Financial Conglomerates)**
The most striking convergence that come into existence in the last decade is intra-industry convergence. The basic

financial services (banking, insurance and securities) from financial service industry are integrating with other non-financial services industry to deliver new kind product, value addition to exciting product, to offer hybrid product by integrating value chains for synergy. The intra-industry convergence generally takes place between basic financial services and the industries which are related to financial services or enablers of financial services. The convergence between financial services and other related or enabler services will create financial conglomerates. The convergence of baking firms with credit card companies, banking services with telecom service provider for for mobile banking , banking and ATM maintaining services, medical insurance , health insurance, Air Travel insurance from insurance sector are best example for intra-industry convergence.

4. **Inter- Industry Convergence(Pure Conglomerates)** The integration of financial service industry with non-financial service industry which is unrelated to financial sector in all aspects are called as inter-industry convergence. The inter-industry convergence will create pure conglomerates. As of now this type of converged products are not come in to picture, but with pace of technological advancements in financial services and high tend competition in the industry will compel the firms to converge with other sector to create new kind of business and products. Today banking, insurance and securities companies are diversifying their business into unrelated areas, later this diversified business may give an opportunity to integrate the industry value chain to create a converged product and services.

7. CONSTRAINTS FOR CONVERGENCE:

1. Compatibility of Services/Products and Technical Feasibility:

The convergence of financial services/ product depends upon the compatibility of services which has to be integrated. The compatibility between product features and value chain process often hinders the convergence, will be higher from inter-related to intra- unrelated. The convergence between two sectors or industries depends on technical feasibility, the extent of convergence in financial services rely on legal limitations and technical classification of financial products of respective countries.

2. Customer Acceptance and Product Complexity:

The lack of clear distinctions between the product that converged and existing traditional services will add confusion in the marketplace among competitors as well as consumers by making it difficult to compare products with similar features or to identify different types of products or product markets. The converged or hybrid offerings are integration of features and process which results in product complexity, the customer will be in confusion to understand whether he is buying banking, insurance or securities service.

3. Government Policy/ Regulatory Mechanism.

The convergence of financial services and hybrid offering in a country has to fit into the government policy and regulatory mechanism. The product that offered in market place in converged form as to follow the legal definitions of financial product classifications. The policies of government and the regulatory system of financial markets limits the levels of convergence.

8. CONCLUSION:

The convergence in financial services and converging companies has to think what would be scalability and viability of converged business. The converged service has to give benefits to companies and customers, it should be sustainable in the long run.

The convergence of financial products signifies an integration of banking, securities, and insurance to a degree that is no longer compatible with the existing regulatory framework based on traditional product distinctions. On the other hand, the existing distinctions of products are still have some relevance in the marketplace(Melanie L. Fein).

The convergence in product offerings by financial services suggests a need for regulatory convergence to reflect the integration of banking, securities, and insurance products in the marketplace. The policy makers has to think what kind of converged regulatory mechanism is required for in converged era.

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