Leveraging the Forces of Change for Enhanced Financial Performance in Gulf Bank

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Abstract

The financial services sector in general and banking sector in particular are in the midst of a revolution. Rapid technological advances combined with changes brought about by globalization, rise of the individual, a more demanding consumer and an ever growing entrepreneurial culture is forcing the banks to do some serious rethinking on their long term strategy. Those banks which are able to leverage these forces of change can aim to survive and improve on their profitability in the future. The challenges ahead call for enhanced efficiency, investment in technology, innovative product and process offering and a global outlook. This research paper closely looks at the shape of financial services industry, and especially banking industry, in year 2010 and how a bank can leverage the forces of change for enhanced financial performance. Gulf Bank, Kuwait which has identified the forces of change and has developed a 'transformation strategy' to reorient the bank and its activities is analyzed for the period 2000-2004 to find out the impact of these strategies on financial performance.

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Introduction

At the turn of the century, Gulf Bank, Kuwait was at cross roads. Profits were flat-lining, the bank was sagging under the weight of low yield Government Debt Bonds (GDBs), and few new products or services had been launched in recent memory. The world was changing. Technology was driving the change in the banking sector. The new millennium called for a paradigm shift in the way banking was done. Gulf Bank did an environmental scanning and based on this instigated a far-reaching 'transformation strategy' in 2000 to turn itself around. This overhaul saw a renewed focus on retail banking, staff restructuring, significant investment into delivery channels, and an IT infrastructure replacement program to ensure that customer data are shared efficiently across the bank in the quest for better customer service and cross-selling opportunities. Customers GDBs were refinanced to be replaced by more profitable corporate loans, and GB really began to turn the corner. Technology became the cornerstone of the new strategy and the driver for increased market share and enhanced profitability.

This research paper aims to find out the how the financial services sector in general and banking sector in particular will be like in 2010. The financial performance of Gulf Bank during the first five years of implementation of the transformation strategy, developed based on an environmental scanning, is analyzed to find out whether the transformation strategy has resulted in a financial turnaround and improved profitability.

Research Objectives

1. To assess the shape of the financial services sector in general and banking sector in particular by the year 2010.
2. To analyze how the forces of change can be used as a driving force for enhanced profitability in the Banking Sector.
3. To evaluate the effectiveness of the 'transformation strategy', with its focus on technology, implemented by Gulf Bank, Kuwait in 2000 and its impact on the financial performance of Gulf Bank during the first five years of implementation.

The research will depend exclusively on secondary data. The sources of data are books, publications, annual reports of Gulf Bank for the period 2000-2004.

The financial performance was analyzed using the following critical parameters,

- Net Profit
- Return on Average Assets
- Return on Average Share holders Funds
- Earnings per share
- Cost to income ratio

The Banking and Financial Services Market by 2010

The 24-hour global market is at hand. The top end of the finance business will increasingly be dominated by a handful of giant institutions serving markets which know no geographical boundaries. Mergers among corporations and stock exchanges will proliferate, distinctions between markets will vanish. Half the stock market's value will lie in the TMT (technology, media, tele communications) sector.

On the contrary, technology will allow institutions to segment their markets more finely and this will encourage the growth of specialized firms catering to very specific needs. The large money institutions like Banks will find their position increasingly challenged by the rise of the private investor. Some big intermediaries could be cut out of the loop altogether by technology which links the providers and users of capital directly. The structure of finance will also change. The growing equity culture will lead to more capital being provided by the markets than by banks. The nature of investment flows will change as well: more will come from individuals and more of it will go into financing entrepreneurship and ethical objectives. *(Allen and Santomero, 1997).*

By 2010, Kuwait Banking sector will witness the impact of globalization. The protectionism enjoyed by the local banks will be a thing of the past. On the economic front, small and mid-sized enterprises will be encouraged to play a substantial role in diversifying the hitherto mono product economy of Kuwait. Many forces will contribute to this. Lack of jobs in the government sector, more number of educated unemployed, financial security encouraging entrepreneurship, advances in computing and communications will encourage the growth of small enterprises in Kuwait. With oil prices expected to rule high at $ 50 per barrel consistently in the near future, economic comfort is guaranteed. Access to capital will improve. Start-up costs will fall. The young generation will be more assertive and will increasingly be attracted by the greater personal satisfaction and money-making opportunities that small business offers.

This shift will create demand for new products and services to finance small business and support an entrepreneurial culture. The traditional role of banks as lenders and hand-holders will decline as more financial needs are met through the investment markets, by business angels, specialized stock exchanges, etc... But SME's will continue to rely on banks for overdrafts and secured loans, as well as for advice and administrative support. Technical literacy will therefore be vital otherwise technology will act to socially and financially exclude rather than include.

Big changes will also occur on the consumer side. In the more competitive, less paternalistic environment that is likely to evolve, the private individual will take on more responsibility for his/her financial affairs. This will require greater financial sophistication and better sources of advice. But technology will help here by providing the consumer with greater choice, better access to information and personal finance software.

The market will become more polarized with a wealthy segment demanding the highest quality banking and investment services at one end, and the less well off looking for simple, low-cost savings and loan products at the other. However, growing market segmentation could also lead to more people finding that no one wants to serve them at all. The providers of financial services will increasingly use electronic means to reach their customers, and may themselves become more "virtual" as they contract out all but a central operating core. Those who work in financial services will have to become highly adaptable and technology-minded to handle the business' growing diversity.

Payment systems will make huge advances by year 2010, to become secure, fast, global, simple and cost effective. Electronic invoicing and payment will become universal, cash will go into slow decline, and cheques will head for extinction. The demands of e-commerce will be a powerful driver. But the needs of the hitherto neglected small payments markets will also be a major force. Access to these systems will become easier with the spread of PCs, mobile phones and other devices, meaning that individuals will be able to make instantaneous payments for virtually any amount anywhere in the world. The payment systems of the future will be based either on movement of money between accounts or on the direct transfer of electronic money (smart cards), and the suppliers of these services need not just be banks: new entrants are likely to compete for them too. Since more people will be dealing electronically with unknown counterparties, there will also be fast-growing demand for trust services to provide safeguards and guarantees.

The Forces of Change

It is important for a Bank to identify the forces of change in order to develop strategies to manage the change to its advantage.

Technology – The next five years will see the completion of the current internet revolution and the start of the next. Massive increases in telecommunications bandwidth, in processing power, and in the supply of online services will transform the financial services marketplace at all levels. For the supplier of financial services it means new power to reach markets, to handle data, to gain competitive advantage. For the user it promises unprecedented access to information and services, the convenience of "any time, anywhere", and a new world of "do-it-yourself" finance.

Globalization - Worldwide 24-hour dealing will very soon produce a global, virtual marketplace which is accessible to anyone with a mobile or a PC. This will lead to huge international flows of capital, ideas and technology, and much tougher competition. The concept of nationally-based investment will fade, to be replaced by global choice. These pressures will speed up the cross-border consolidation of companies, banks and stock exchanges. The process will also spread down the scale to spawn multinational SMEs, and companies occupying "global niches". The emergence of B2B markets will open up a new world of global, low cost procurement.

Private investors will increasingly invest globally. Geography will also die in a local sense. The growth of remote trading and banking through the internet will lead to a reduction in the physical presence of banks: of branches, of face-to-face service. We will almost certainly see a single Regional and possibly global equities exchange, especially for the largest multinational and, probably still separately, for growth companies. Existing electronic infrastructure, including trading, clearing and settlement, will have been rationalized on a pan-regional basis and possibly globally, permitting seamless, paperless and cost-efficient, 24-hour trading for institutions and individuals. Developments in telecommunications bandwidth combined with further advances in processing power will have reduced the cost of most information and electronic processing to zero. Technology will also permit greater customer segmentation, with high quality services flowing to the most attractive and profitable corporate customers.

Rise of the individual - The growing importance of the individual - as entrepreneur, investor, and consumer - will mark one of the big changes of the coming decade. Improved market access, better technology and information, and growing financial sophistication will allow him/her to participate directly in markets rather than via institutions. This will impact the nature of demand for financial services, as well as market behaviour.

Entrepreneurs - more individuals will set up their own business; more professional people will quit organizations where they are working to go it alone, more people will work at times and places to suit themselves.

Consumers – The individual will start taking more control over his/her financial affairs and hence will demand a fuller range of financial products. People will become more discerning, more ready to shop around; this means less inertia, but also less loyalty. In many cases, the distinction between the retail customer and small business customer will become quite blurred. But a more financially active consumer will also need more help and advice: better price information, clearer choices, and regular financial health checks. Some of this will come from familiar sources (e.g. independent financial advisers, the Press). But more will be delivered by technology (search engines, electronic decision-makers, ready-reckoners). Greater customer knowledge will be the key and this is likely to mean lower monitoring costs and better cross selling, as many studies have illustrated *(Mester, Nakamura, and Renault, 1999, and, Hitt, Frei and Harker, 1999).*

Impact of forces of change on the Banking Sector

Let us have a look at the impact of these changes on the banking sector. The shape of the finance industry in general and banking sector in particular will see dramatic changes. Financial institutions will have a huge range of strategic choices: to be broad or narrow, high or low added value, multi-line or specialist. Divergent trends will therefore emerge. On the one hand, globalization and economies of scale will encourage the growth of super-large institutions geared to compete in all markets, armed with globally competitive skills. This consolidation will spread across business sectors, for example by bringing banking and insurance together. In the context of the banking industry, it is sometimes stated that when economies are found, they are often arise in large specialized firms exploiting a single line of business, not in huge universal banks *(Steinherr, 1996).*But even as the big get bigger, there will be a proliferation of new competitors at the small end, exploiting low-cost delivery channels, and targeting selected markets. Some institutions will choose to be leaders in low cost products, others will move up the value chain to escape the margin pressures of commoditization. The structure of institutions will also change. The growth in outsourcing will lead to more networking: a large bank may only employ a few dozen people at the centre, having contracted out all its operations.

This will not be a market where the winner takes all. The pace of change and the ease of market entry mean there will be a succession of winners - and losers. The winning strategies will be those that aim to satisfy an increasingly discerning business and retail market. Effective use of technology will be the key differentiator.

The changing financial marketplace will require the banks to be more innovative in product offerings. There will be a need for more varied and flexible products: loans to suit different types of businesses and consumers, from the most sophisticated to the most straightforward: wealth management and advisory services, services for the sub-prime market. But though many of these will have to be newly-designed, there will continue to be demand for traditional products and delivery channels, such as face-to-face banking. The payments world of 2010 will offer a richer array of payment products. It will have developed further, faster than in any past decade. Existing payment products will have adapted and evolved to the world of the internet, mobile communications and electronic commerce and new payment products will have been created to plug the major gaps in the market.

The pricing of products will become much sharper in a marketplace that will be increasingly price-driven. Greater transparency also means less cross-subsidization within institutions, which could spell an end to "free" banking. Bankers will need to acquire finer credit skills to differentiate new types of business, and value companies whose assets are increasingly intangible: knowledge and intellectual property. New models will emerge for matching users and providers of funds, and in the value chain for credit. Banks' traditional intermediation role will be undermined by extremely low search and interaction costs on the internet. Roles in the value chain for credit will be unbundled. Lending institutions will have to learn how to value intangible assets when looking for security.

Electronic Commerce is central to what lies ahead, and the way should be cleared to allow it to evolve as rapidly as possible. Development of E-Commerce is a direct off shoot of the rapid improvements in technology. As with the enterprise culture, this means creating friendly tax and regulatory conditions. But it also means creating a technological and institutional framework within which the infrastructure of the new economy can be built and made available. If motorways were the key to the last century, then broadband networks are the key to the new century. Affordable broadband services will alter the entire banking scenario. E-commerce will fundamentally change most traditional SMEs, through improving basic business processes, e.g. reducing costs through e-procurement, remote training of staff. E-Commerce will also in the long run reduce the operating cost of Banks with the cost of transaction likely to be nearly zero. This will have a positive impact on the profitability.

Technological changes will affect the banking operations in another way. Cheap computing and communications will disperse back office operations, pushing some forward to sales forces' laptops and others towards centralized data processing warehouses; few processes will be left at the intermediate staging post of a local "branch". This will mean investment in technology and training while reduction in conventional administrative expenses. Distribution will develop further to provide customers with a choice of remote access channels (both telephone and screen-based); behind this, customers will increasingly expect to see real-time processing of their funds transfer or investment instructions. Smart card technology will provide a viable alternative to cash, and will also be developed to facilitate account portability.

These developments will however pose challenges for the nature and scale of existing branch networks. We are likely to see smaller branches with lesser manpower or even a scenario where the need for branches will totally be eliminated. These forces for change will interact to create a different landscape in 2010 to that which exists today - one which exhibits much more "biodiversity" both with regard to consumers, providers, and products than is the case today.

Technology will increase market and operational efficiency leading to higher profitability. By 2010 technology will have enabled widespread and low cost distribution of financial service product offerings. New, electronic-based entrants will have emerged such as have successfully already occurred in Germany, permitting wider and more cost effective access to capital markets for both suppliers and consumers of capital. This should enable more transparent and frictionless movement of capital, albeit reducing scope for inefficiencies or excess profitability within existing business models, further increasing pressure on established participants but better serving the wealth creation process. In addition, the electronic infrastructure, particularly clearing and settlement, will have been rationalized into paperless platform.

By 2010 we will see payment systems that: are secure, fast, global, simple and cost effective, take advantage of the available technology and security mechanisms, address the emerging needs of a range of markets including e-markets and consumer-to-consumer and small value payments markets, offer users the option of traditional payment products or a range of electronic payment products and are offered by a range of new players as well as traditional players, such as banks. By 2010 there will be global payments systems able to support this activity cost effectively, for small as well as large payments, domestic as well as cross border. Customers will be able to choose from a range of payment products that will meet the needs of almost all payment circumstances. This range will include same-day, fast account-to account payment products with global reach and global electronic purse products which will allow them to transfer electronic money almost instantaneously. Individuals and businesses will be able to initiate payments conveniently and securely, using PCs, mobile phones and other devices for communicating their instructions to banks. They will also be able to receive notification of incoming payments on these devices and will have access to account information. Cheques will be a threatened species, heading for extinction. Cash will be in slow decline but still with a ten to twenty year future.

Multifunction smartcards (or other devices, such as mobile phones, which contain chips) will replace magnetic stripe cards and will be the main payment instrument for individuals. Consumers will use them to make "traditional" plastic card payments, across the counter or remotely over the Internet from a range of devices - mobile phones, PCs ATMs/kiosks. The chip will provide security, binding the cardholder's identity to the transaction. Small value transactions, including purchases from vending machines, will be made quickly and conveniently using the electronic purse functionality. And there will be smartcards holding "real electronic money" which will be instantaneously transferable to individuals or businesses, face-to-face or remotely. Smartcards will also hold a range of tokens issued by retailers, telephone companies and transport operators. They will also be used to sign electronic documents.

Leveraging the forces of change – Transformation Strategy of Gulf Bank

In 1999, Gulf Bank, Kuwait was stagnating. The Bank was losing its competitive edge. The products were obsolete and it was not able to attract new customers. It was not being innovative and was in danger of being muscled out of the top 3 in the Kuwait Banking Industry.

Gulf Bank embarked on a voyage of turning the Bank around. It took into account the changes that are likely to happen in the first decade of the new century. Having identified technology as the main driver, it developed a 'Transformation Strategy' which revolved around the effective usage of technology. Technology was to be the core competency of the future. This strategy called for a refocusing on retail banking, restructuring of manpower, modernization of delivery channels which called for major investments, and an up-gradation of the IT infrastructure to ensure that customer data are shared efficiently across the bank in the quest for better customer service and cross-selling opportunities. Customers GDBs were refinanced to be replaced by more profitable corporate loans and the results were visible immediately. Technology became the cornerstone of the new strategy and the driver for increased market share and enhanced profitability.

The bank redefined its core systems and in 2003 developed the channel offering as it entered the phase two of the transformation strategy - the part where it started to reap the rewards of three years of investment. In December 2003, GB went live with the I-Flex Flexcube core banking system to meets its treasury, trade finance and corporate loan transaction processing needs. At the same time it also implemented Flexcube @, an Internet banking solution designed to support multi-channel access and self-service touch points.

Despite the fact that the transformation strategy is still not been implemented fully, the bank has managed to report strong core earnings and operating profit growth since it launched 20 new banking products in 2001.

In its endeavor to refocus on retail banking, GB decided to position itself as a value-added service provider. It took a conscious decision to not project an image of a cheap bank, a stance also taken by the corporate division, but it strived to demonstrate that it is giving the customer something more than the competition. The aim was to start bundling the products, a very new concept in Kuwait. For example if a customer is checking, loans, and credit cards, additional services are provided to suit the target market segment. The innovation was not in a particular product, but in how the product was packaged for customers.

Investment in technology helped Gulf Bank to react quickly to customer requests and became a key differentiator. It also enabled it to be the first in Kuwait in providing same day response on loans and cards

New branches were added and the banks were provided with cutting edge technology. This meant equipping branches with multi-currency drive-thru ATMs and cheque lodging machines. E-banking is also available through the Internet (separate services dedicated to retail and corporate customers), and through mobile channels such as WAP and SMS. Gulf Bank launched on-line trading in partnership with a US on-line brokerage: Ameritrade. Though the bank is effectively leveraging its Web presence as a conduit for Ameritrade transactions, earning fee income in the process, the value of the service to the bank has been that it offers customers a one-stop bank-branded portal for stock, bond, options and margin trading. The replacement of the Bank's major IT systems and IT infrastructure has provided a new technological look to the Banks operation. Currently over 83% of the banks transactions are handled electronically. Investment in IT along with business process reengineering has simplified work practices, eliminated unnecessary or redundant processes, resulting in efficient utilization of all resources, making Gulf Bank a more efficient, flexible, innovative and fundamentally profitable bank. Technology was used to provide additional services like internet banking services, mobile banking services and tele banking services.

The forces of change also called for servicing the high margin commercial customers speedily and effectively Corporate loan decisions were speeded up. The internal authorization structures were amended to avoid decisions being escalated to the entire board. Delegation meant that decisions on major transactions could be taken in a single day, if necessary. The bank adopted a partnership approach to corporate banking rather than simply being a lender and commodity provider. The corporate market was segmented as: commercial, SME, financial markets, and contracting, for making specialized offerings. This ensures that GB maintains the second largest corporate loans portfolio in Kuwait.

Along with retail and corporate, keeping in tune with globalization requirements, Gulf Bank as a part of its strategy developed its international banking operations. Customization is the name of the game here and products were developed to serve foreign customers who undertake projects in Kuwait, as well as oil trade finance and correspondent bank relationship management. Landmark initiatives include the syndication co-arranging of the largest project undertaken in Kuwait in 2002, a

KD120 million BOT waste-water project, and participation in two of 2003's largest domestic deals: a KD130 million power plant built by Siemens, and a KD42 million oil facility enhancement undertaken by LG Engineering. The success of these products has led Gulf Bank to think in terms of increasing income from off-balance sheet sources such as risk participations, as well as guarantee provisions and Forex work.

The transformation strategy is aimed at deepening of GB's deposit base. The constraint of the local market means that Gulf Bank has to diversify assets into non correlated markets. The banks first overseas subsidiary was started in 2003 in Bahrain. The bank also is aiming to leverage the regional shift towards Islamic Banking products by launching sharia compliant products.

Analysis of Financial Performance for the period 2000-2004

The financial performance of Gulf Bank was evaluated for the period 2000-2004 to find out how the implementation of the transformation strategy has affected the financial health of the bank.

Table 1: Key financial indicators of Gulf Bank for the period 2000-2004

Financial Indicators / Year	2000	2001	2002	2003	2004
Net Profit *(KD Million)*	35.4	42.1	45.5	48.5	74.6
Return on Average Assets *(%)*	2.07	2.39	2.35	2.16	3.13
Return on Average Shareholders funds (%)	19.8	21.9	21.4	20.0	28.4
Earnings per Share *(fils)*	45.4	51.9	56.9	60.8	91.3
Cost to Income Ratio *(%)*	26.6	24.1	24.2	22.0	18.1

Source: Gulf Bank Annual Reports 2000-2004

Gulf Banks financial performance during the five year period 2000-2004 has shown steady improvement. The net profit has increased to KD 74.6 million in 2004 from KD 35.4 million in 2000. The return on average assets has grown to 3.13% from 2.07% during the same period. 3.13% is considered to be impressive by international banking standards. The same can be said of return on average shareholders funds which is 28.4% in 2004 as compared to 19.8% in 2000. The bank has started reaping benefits from the investments made in the first three years of transformation strategy by showing a considerable increase in its earnings per share in 2004. The earnings per share of 91.3 fils is double the earnings per share of 45.4 fils in 2000. The most noticeable indicator is the cost to income ratio. Despite increase in costs due to higher investment, the higher growth on return on investment has ensured that the cost to income ratio has steadily declined. Gulf Banks cost to income ratio of 18.1% in 2004 is the lowest in the industry and is a strong indicator of the operational efficiency.

Conclusion

Leveraging the forces of change and adoption of cutting edge technology has positively affected the financial performance of Gulf Bank during the research period 2000-2004. This is despite the bank investing heavily on technology during the Phase I of its 'Transformation Strategy'. The bank is well positioned to benefit from its investment in technology and is poised to orchestrate its technologically advanced resources more fully in order to gear up to meet the demands of the banking sector in 2010.

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