CE Center for Effective Organizations

Adding Value in Banking: An Innovative Human Reosource Strategy

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Abstract

There is a widely held view among business scholars and practitioners that many service sector firms are caught in a "cycle of failure." Rather than using customization and integrated service delivery to take advantage of a new quality consciousness of consumers, service sector managers continue to focus on cost-cutting and price competition. Conventional explanations for this failure have focused on managerial decision-making.

Drawing on evidence from the banking sector, this paper suggests a different explanation for the cycle of failure in the service economy. The low-levels of skill among school-leavers and the absence of barriers to the mobility of skilled employees creates a labor market environment which discourages investment in human resources. Raising levels of human capital investment to improve the quality of service delivery can be done but it requires restructuring recruiting and training practices in light of institutional constraints.

Introduction

A quality revolution is underway in the U.S. service economy. Over a decade after the onset of deregulation in leading service industries, consumers have grown accustomed to and expect their service providers to be price-competitive. Now, they are increasingly demanding higher levels of service quality. Staying competitive for service companies means not only offering their products at reasonable prices, but being able to tailor these products to meet the needs of individual customers.[1]

Some companies have been quick to get ahead of this quality revolution.[2] Delta Dental Plan of Massachusetts, a health insurance provider, and MBNA, a credit card provider, have both used quality service delivery to turn middling businesses into industry leaders. Merrill Lynch, a brokerage house, and IKEA, a Swedish-based retailer active in many parts of the U.S., have relied on quality-oriented service strategies to keep their organizations high-performing and competitive. All four companies have redesigned their work practices to leverage information across different products and provide customers with quick, customized and price competitive service offerings. Employees directly involved in service delivery have been trained and empowered to undertake a broader range of tasks. Priority has been placed on minimizing labor turnover, on the theory that employees with longer tenure have a better understanding of both a firm's customers and its internal work processes and so are better able to meet individual client's needs.

Yet, companies such as these are the exception. Many, if not most, service sector firms have been slow to adopt new approaches to quality. From hotels to banks and retail outlets, service sector managers continue to rely on an "industrial model" of service delivery.[3] They have organized work in such a way as to tolerate low-skills and short employment tenures and continue to concentrate on cutting costs rather than adding value. Thinking mainly in terms of price-competition, most service managers have invested minimally in their people. Downward pressure on wages, minimal training expenditures and heavy use of part-time and temporary employees have reduced personnel costs and maintained manager's flexibility to cut the workforce when demand slackens.

Conventional explanations for the failure of more service sector firms to take advantage of the quality revolution have focused on managerial decision-making. Unwarranted faith in the powers of information technology, a commitment to scientific management, and historical antipathies between management and labor are all said to have discouraged managers from designing their competitive strategies around high-skill and high-quality work organizations.[4] In this view, reorienting business strategies to take advantage of the new quality consciousness of consumer is assumed to be primarily a function of changing managerial attitudes. Once service sector managers understand the importance of customization for their competitive prospects in the new economy, they will simply rewrite their human resource policies and practices.

Using the U.S. banking sector as a case study, this article suggests the need to rethink both the causes of and remedies for what has been termed the "cycle of failure" in the U.S. service economy. As the financial services market has become more competitive, an emphasis on building strong financial relationships to support customization of product and quality service delivery would seem to be a natural source of competitive advantage for commercial banks. What distinguishes banks most from other financial service providers is their extensive branch network. The high overhead associated with maintaining a large number of branches makes it difficult for banks to be low-cost leaders in the financial services market.

The high level of customer contact provided by branch offices, moreover, offers banks plentiful opportunities to use integrated service delivery and relationship management to cross-sell products. While a relationship management strategy will not be appropriate for all market segments in which banks operate, it can be a particularly strong source of competitive advantage in attracting high-end retail customers and small- and medium-sized business enterprises. Both types of customers have sophisticated financial service needs which span a variety product markets, but may not have the time or knowledge necessary to manage their finances on their own.

Judging from the amount of rhetoric in recent years about the need for better customer focus and improved relationship management, banks seem to recognize the importance of integrating quality into their service delivery. In practice, however, most banks continue to focus on reducing labor costs and competing on price. Those which have invested sufficiently in their human resources to support product strategies based on customization and integrated service delivery are in a small minority.

We argue in this paper that the failure of more banks to integrate quality into their competitive strategies cannot be explained simply in terms of management decision-making, but must be understood in the context of a labor market environment which discourages managers from investing in human resources.[5] As in other industries, the low level of educational and vocational attainment among U.S. school leavers means that young persons come to banks ill-prepared to take on complex job tasks. The absence of barriers to the mobility of skilled labor also makes it difficult for banks to invest in training and to design service delivery with the assumption of long employment tenures. Both aspects of the American labor market have made it easier for banks to react to higher levels of competitive pressure by emphasizing price-competition and standardization, e.g. "commodization," rather than by concentrating on adding value.

Overcoming the low-skill environment to shift to a high-quality service strategy can be done, but it requires attention to institutional constraints. We suggest two types of human resource and organizational innovations. First, banks can increase skill levels and reduce turnover by creating a new employment contract which emphasizes competence-based career ladders for entry-level employees, modular training for high-skill positions, and higher levels of internal recruitment. Second, banks can lower their training costs and raise the skill level of new recruits through educational partnerships with community colleges and four-year universities. By making completion of certain courses a criterion for hire, banks can get employees and the government to pay for initial, general skills training.

The paper is based on 30 interviews with branch managers and senior executives in a dozen different banking institutions.[6] Evidence on human resource developments and market trends in the banking industry has also been gathered from industry consultants, bank employers' organizations, and a review of the relevant literature. While the discussion in this paper is centered on banks, we believe that the analysis of the effects of a low-skill environment on firms' human resource decision-making and the suggested organizational remedies have a broader applicability throughout the service economy.

Banking as an Industry in Transition

The last decade has seen profound changes in the U.S. banking industry. On the supply side of the banking market, regulatory and market changes have lead to higher levels of competition between suppliers of financial service products. The loosening of regulatory restrictions on depository institutions has allowed thrifts and commercial banks to expand the range of standard banking services they offer and in many states allowed them to enter markets for investment and insurance products. Advances in information and communication technology have permitted finance companies, insurance dealers and other non-banking firms to enter the retail banking market without networks of branch offices. Firms like Sears and Ford Motor Company now provide consumer credit, while other traditionally one product companies such AA Insurance and American Express sell deposit products, checking services, and credit cards.

A second factor contributing to dynamic change in the banking industry is a shift in patterns of consumer demand. Consumers are using some retail products more intensively while also beginning to expand into investment and insurance products. Between 1980 and 1992, deposits as a percentage of personal assets dropped by 10%, while investments in mutual funds, money market funds and government bonds increased by 10% and holdings in life insurance by 6%.[7] Meanwhile, bank loans for personal consumption expanded rapidly during the 1980s, as more individuals took on debt to finance their education, mortgages and purchases of consumer durables. The interest in and need for help with international financial opportunities also increased. High-end retail consumers turned to international financial markets to make investments while an increasing number of small- and medium-sized enterprises looked for help in expanding into overseas markets.[8]

A third factor which has contributed to volatility in the banking industry is the trend toward financial disintermediation. As large firms have turned to bond and commercial paper markets to meet their short- and long-term financing needs, diversified commercial banks have been left to compete over lending opportunities to small and medium-sized enterprises.[9] Maintaining market share in the middle- and lower-end of the wholesale segment has been complicated by the increasing market presence of venture capital firms and small independent wholesale banks. Both types of institutions have attempted to carve out a market niche for themselves by working more flexibly with start-up firms or specializing in particular economic sectors.

Competitive Responses

A small number of banks have responded to these market trends by raising the quality of their service delivery. Two very different banks, Citibank and California Federal Bank, a Los-Angeles-based former savings and loan, have reacted to the increasing sophistication of consumers with banking strategies aimed at relationship management. Both firms were quick to take advantage of the loosening of restrictions on banks' involvement in insurance and investment products as well as the growing demand for consumer credit products to create a financial manager position in their branch offices.

In 1993 Citibank began training some of its platform employees comprehensively in deposit, investment and consumer credit products to allow them to act as financial advisors for high-end clients. By leveraging information across a number of different areas, Citibank hopes to raise the quality and convenience of financial service delivery to its wealthy private customers. Like Citibank, California Federal Bank has integrated investment services directly into its branch operations, training new account employees to deliver insurance, mutual funds and progressively more complex investment products. CalFed began a program in 1994 to have its branch-based financial managers develop comprehensive financial plans spanning deposit, investment, and insurance products for its retail clients.

First Federal Bank, a southern California-based federal savings bank, has taken the relationship banking strategy a step further. To support its niche market strategy of targeting older, more conservative consumers, the bank puts a premium on service quality and employee stability. Teller and new account officers are expected to use long-term relationships with clients to cross-sell deposit , consumer credit, and simple investment products. One First Federal executive summed up the bank's business philosophy saying, "knowing customers personally and being familiar with their individual financial needs is a source of competitive advantage ... It facilitates customizing product and makes it more difficult for customers to leave the bank."

In the wholesale segment, Harris Bank of Chicago has pursued a similar strategy. While other banks neglect smaller business customers to focus on large corporate clients, Harris Bank has formed a special lending group which focuses on building long-term relationships with firms having $5-$100 million in annual sales. Rather than maximize short-term profits by extending revolving credits, the bank's goal according to a senior executive for commercial lending is "to serve its clients' needs over the life-cycle of the company." They have prioritized developing a stable set of relationship managers who have a working knowledge of their clients' and their clients' industries.

What all these banks have in common is that they are using a relationship model of service delivery to gain competitive advantage (Table 1). The increasing array of financial products in both the wholesale and retail segment creates a market opportunity for those banking institutions that are able to use skilled bank employees to minimize the time and cost to customers of navigating their way through the complex world of finance. By allowing a single, broadly skilled employee to attend to all the needs of individual customers, these banks can promise speed, convenience, and customization in service delivery.[10]

The Drive Toward Commodization[11]

In responding to higher levels of competitive pressure by increasing the quality of their service delivery, the banks described above are an exception. Most U.S. banks have responded to the intensification of competition in the financial services market by adopting an explicitly transaction-oriented banking paradigm (Table 1). Rather than attempting to improve using their branch offices to cultivate strong customer relationships, most banks have tried to outcompete one another and other financial service firms along the dimensions of price and convenience.

Retail Banking. In the retail segment, banks' primary competitive response to higher levels of competition has been intensified price competition and an emphasis on developing new twists on standard banking products. By frequently changing fee schedules and interest rate returns or by offering special give-aways (e.g. air miles, prize drawings), banks have maintained a fairly high pace of innovation in their product offerings. Monthly or quarterly product campaigns are used to undercut competitors and attract price-conscious consumers.

Table 1: Strategic Alternatives

	Relationship-Orientation	***Transaction-Orientation***
Competitive Principles	Customization & advising "One-stop" service	Price competition Self-service
Use of Information Technology	Medium investment in IT IT complements human capital	Heavy investment in IT IT replaces human capital
Skilling & Staffing Needs	Broad skilling Low employee turnover	Job-specific skilling Employees interchangeable

Another strategy to win new business has been a redoubled emphasis on convenience in service provision. Investment in convenience-enhancing automatic teller machines increased steadily over the course of the 1980s, with the density of ATMs per inhabitant increasing from 205 per million residents in 1983 to 340 by 1991.[12] Opening hours on weekends and in the early evenings, promises of short-waiting periods, and offers of the convenience of twenty-four hour telephone-banking have also entered the competitive fray. Typical of the attempt to win business through higher levels of service convenience is Bank of America's recently launched "I can banking" business campaign. Promises of an ATM “on every corner,” quickly approved consumer loans, and the ability to conduct much banking business over the telephone are being used to try to win market share.

The drive to reduce costs and increase investment in information technology has been accompanied by a wave of mergers and acquisitions. Between the mid-1980s and mid-1990s, the number of American banks shrank by almost a quarter from 14,000 to 11,000, and most experts predict continued rapid consolidation.[13] Industry consolidations has been driven in part by the attempt to overcome the and inefficiencies created by erstwhile regulatory restrictions on interstate banking. More recently, the drive towards consolidation has been reinforced by the need for higher levels of investment in information technology. The shift towards non-branch distribution channels and demands for continued cost-cutting in administrative areas has made high levels of investment in information technology an imperative.

As they have shifted toward transaction-oriented banking strategies, most banks have been keener to use human resource policies to generate cost savings than to build a skilled and stable workforce. As our research and other industry studies indicate, most banks spend little on training frontline employees and keep work organization highly segmented.[14] Tellers perform a limited range of tasks, from taking payments and cashing checks to checking account balances, referring customers to specialists for opening new accounts or new consumer credit. Investment services, are often sub-contracted to independent consultants. The fragmented structure of service delivery allows banks to save on costs by keeping training short and functionally-oriented.

Cost savings have also been generated by shifting away from a full-time to a part-time labor force. Across the banking industry as a whole, the percentage of tellers working on a part-time basis went from a near zero in the mid-1980s to 60% by the early 1990s.[15] Some large commercial banks, are now making the new accounts positions part-time as well. In a number of banks we visited part-timers accounted for nearly three-quarters of the branch labor force.

A third human resource strategy designed to help banks minimize training costs has been a shift to external recruitment for high-skill branch positions. Our company interviews suggest that while 80% of branch managers are promoted from within, half of all the consumer credit officers and 80% of investment advisors are recruited externally. Of these three positions, it is only the branch manager who can learn most of the required skills on-the-job. Both consumer credit and investment advising require considerable extra product and technical training.

Table 2: Annual Turnover in Different Employment Positions

Position	Annual Employee Turnover
Average figure	22%
Consumer Credit Officer	50%
Teller, New Accounts	35-40%
Commercial Lenders	33%
Branch Manager	10-15%
Executives	10-12%

Sources: Koenig, Kathryn: Survey of Bank Personnel Policies and Practices, Vol. 1. Rolling Meadows, Illinois: Bank Administration Institute 1991; Company Data

Low levels of investment in human resources have helped banks generate cost savings but it has also had a down-side in the form of high levels of employee turnover. Part-time employees with poor prospects for upward mobility make less committed employees. They are either constantly in search of a full-time job or have priorities outside of work, e.g. studies or parenting, which encourage frequent job switching. Similarly, mid-career specialists who have been poached from a rival can be expected to have low levels of loyalty to their employing firm. Annual turnover in the banking industry ranges from an average of 35-40% in the teller and new accounts positions to as high as 50% among consumer credit officers (Table 2).

Because of their commitment to a transaction-based banking paradigm, bank executives have not been very concerned with employee turnover. Customers are expected to be attracted to a bank by promises of price reductions and service convenience, not through offers of integrated and high quality service provision. One branch manager said that executives in her bank had a "warm-body" philosophy of human resource management -- they were concerned with having employees to fill branch-level positions, but did not particularly care who these employees were.

Wholesale Banking. In wholesale banking, the shift toward a transaction-based banking has been clearest in the small business segment. This market segment is made up of professionals, owners of small retail shops and artisans, e.g. plumbers or carpenters. Traditionally this class of customer has been treated as a special category of banking customer, with many branch managers acting as relationship managers.

Over the course of the last decade, the trend among many large banks has been to strip small business clients of this special status. They have been asked increasingly to develop their investment and deposit services through the same channels as normal private customers. For many banks, moreover, evaluation of small business loan applications, just like evaluations of credit cards, has become a centralized, back-office affair. They are carried out with the aid of a computer risk-assessment program by employees who have no contact to the small business client and no knowledge of his or her business's particular circumstances.

In the middle-market segment, many bank managers we interviewed claimed to be moving toward a "relationship management" strategy, recognizing that this is a market segment rich with possibilities for cross-selling products. The typical middle-market firm is a small- or medium-sized manufacturer, with between $5-250 million in annual sales volume. It is a size of firm which has not only the credit and deposit needs of the small business enterprise, but also requires additional sophisticated investment advising, cash management services, access to other electronic banking products, and increasingly international banking services.

Despite this rhetorical commitment to relationship banking, the way banks develop business with their middle-market clients is still often characterized more by transaction- rather than relationship-based thinking. Rather than working with their small- and medium-sized firm on a long-term basis, many commercial banks are keener to avoid risk and to earn what they can from short-term business deals. A disproportionate amount of capital offered to firm clients comes in the form of either revolving lines of credit or loans with short-term maturity dates. Estimates suggest that no more than 20 to 25% of the credit offered by large commercial banks has a term-date of 3-years or longer.[16] Commercial banks use short-term loans to pursue pro-cyclical lending. In times of prosperity, when they have excess capital at their disposal, banks are very generous in their interest offerings. In times of recession, they curtail their lending operations severely.[17]

The transaction-driven strategy reveals itself also in the heavy emphasis commercial lenders place on customer acquisition rather than customer cultivation. Our interviews suggest that the typical relationship manager spends at least half of his or her time trying to find new clients. This emphasis on customer acquisition cuts down on the amount of time commercial lenders have for generating new business with existing clients. According to one study, in some banks the percentage of time spent by commercial lenders on customer cultivation may be as low as 20%.[18]

Many of the large commercial banks we interviewed also employ two or three individuals per lending group whose major or sole responsibility it is to solicit new business. These individuals either follow-up on referrals or simply cold-call potential customers, with cold-calling alone accounting for as much as 65-70% of the new business generated in some banks. Efforts to win new customers normally revolve around promises of lower interest rates on loans and lower prices on related financial service products. Price competition between banks is often so intense that the margins earned on loans become razor thin.[19]

Business Strategies and Economic Outcomes

In some customer segments, the transaction-oriented approach to banking makes clear strategic sense. According to bank executives, large corporations are extremely price sensitive and are willing to compete banks off against one another to get the lowest possible offer on both credit and non-credit products. This size of customer has the financial expertise it needs to conduct cash management, investments, and international banking operations and thus expects simple, efficient services from its bank(s). At the low-end of the retail banking market, there are a large number of customers with relatively unsophisticated financial service needs and low profit potential. These customers are price-sensitive and use only minimal bank services.

Banks operating in these more standardized markets need to radically rethink their cost and delivery structures if they are to remain price competitive with the growing number of non-bank alternatives. They need to dismantle their very cost intensive branch structures, to make maximal use of information technology and to figure out ways to minimize the use of human resources in service delivery.

Between these highly price-competitive ends of the banking market, however, there are a large number of customers who need and could value a more intensive relationship with their bank. These include small business owners who need help managing both their private and business finances, middle-sized business owners who want not just bank credit but also a banker with perspective on their market and industry, retirees who must achieve the appropriate balance between liquidity and investment, young professional who need a strategy to pay off student loans while also begin to invest for their children's education and their own retirement.

Innovative banks have used a relationship management strategy with customers like these to generate competitive advantage. In the fiscal year 1994-1995, one year after launching its relationship management program for high-end clients, Citibank was able to bank to significantly increase the number of high-end accounts under management and increase the revenue generated per account. First Federal's strategy of focusing its marketing efforts on cross-selling existing clients rather than more general product promotions has resulted in a significant reduction in single service clients and an increase in account retention. In 1995, single service clients fell by 12% and account retention increased by 58%.

Harris Bank's strategy of developing in-depth knowledge of their customers and their customers' industries has led to a customer retention rate well above the industry average. In a market segment where many customers switch banks every three to five years, Harris Bank has used its intensive relationship management strategy to realize a whopping twenty-year average length of relationship with its middle market clients. California Federal's strategy of creating comprehensive financial plans for its firm clients has supported the banks efforts to cross-sell customers. Seventy-five percent of the customers which in the 1994 roll-out of the comprehensive financial plan moved accounts from other banks to begin to consolidate their retail banking products with CalFed.

At the level of the banking industry, the failure of more banks to adopt relationship-oriented business strategies in the market segments for high-end retail customers and small- and medium-sized customers has been an important cause of bank's falling market share in financial services markets.[20] In the retail banking segment, banks have failed to use their branch offices to reach high-end clients. For the retail banking consumer, each new type of financial account opened with a bank brings new search and information costs. Moving from a deposit account to an investment or insurance product means that a customer will have to deal with a different bank employee and may need to go to a different physical location. The fragmentation of bank's service delivery makes it easier for customers to be enticed away by lower cost, single-service financial service providers.

In their commercial lending operations, the shift towards short-term, acquisition-oriented business strategies has had a similar deleterious effect on banks' competitive prospects. All else held equal, given the choice between a bank loan, direct access to capital markets or raising funds privately, a firm of any size naturally prefers one of the latter two options. Issuing bonds and equities directly in capital markets or raising funds from private sources not only reduces the cost of capital but it also minimizes external interference in internal business decision-making. A bank loan only becomes more attractive, if it suggests a stable source of funding -- even through times of economic difficulty -- and comes with customized service and financial advising.[21]

As large, diversified commercial banks turned toward standardization and automation, an increasing number of middle-market firms turned to directly accessing capital markets, to venture capital firms, and to independent wholesalers.[22] Many small firms have also exited the banking system, choosing to raise funds privately rather than rely on "stop-go" lending from banks. With banker's adding less value to their business operations, there has been less incentive for small- and medium-sized enterprises to raise funds within the banking system.

A Low Skill Environment

If market trends support a shift toward relationship management in many of banks' key market segments, why have most banks moved toward the transaction-based paradigm? As noted earlier, conventional explanations for the failure of more service sector firms to integrate quality and customization into their business strategies have focused on the shortcomings of managerial decision-making. What the conventional view misses, however, is that the trend toward commodization of services is a function not simply of management decision-making but rather of the interaction between management decision-making and institutional constraints. American banks have found it difficult to generate a skilled and stable labor force owing to institutional barriers presented by the labor market environment in which they operate.

Poor Vocational Skills of School Leavers -- As in other sectors of the U.S. economy, there are few mechanisms to prepare young persons for a career in banking. Entry-level hires typically have scant knowledge of financial services, have no previous experience working in a bank, and, in many cases, lack a sound educational foundation.[23] "It is not just that their basic skills in reading, writing and arithmetic are lacking, said one human resource manager, "but we also have problems finding good social skills and proper manners." Several of the human resource executives we interviewed noted a steady decline in the quality of applicants for entry-level branch positions. Citibank has responded to this problem by petitioning several state governments to absorb some of the costs of training individuals who lack sufficient basic skills. Even for higher skill positions, managers often complain that what new recruits learn at university is too removed from the world of work. As the manager of one commercial lending group noted: "We can get accounting majors in here that don't know how to do a decipher an annual report for a real company."

Table 3: Salary range in Different Employment Positions, California Banks

Employment Position	1st Quartile	Average	3rd Quartile
Branch Manager (>$50mill)	$44,574	$57,592	$70,610
Branch Manager ($20-$50 mil)	$41,655	$53,985	$66,314
Branch Manager (<20$ mil)	$35,838	$46,533	$57,227
Commercial Lender (VP)	$40,174	$52,102	$64,030
Commercial Lender (AVP)	$30,784	$39,375	$47,967
Consumer Credit Officer	$25,186	$32,641	$40,095
Investment Adviser	$18,524	$23,463	$28,402
New Accounts	$15,566	$19,633	$23,710
Teller	$13,068	$16,208	$19,348

Source : Deloitte & Touche, California Bank's Compensation Survey 1992

The poor vocational preparation of school-leavers at all levels encourages banks to design their product strategies around low skills rather than make the considerable training investment necessary to base their product strategies on high quality and integrated service deliver. The level of technical skill and product knowledge required to move toward an integrated model of service delivery is well above that of the average school leaver.

Problems of Poaching -- A second barrier to achieving relationship-oriented banking strategies is the problem of poaching. As in most U.S. service sectors, collective wage agreements play no role in wage determination in the banking industry. Each bank decides independently on its compensation policies and practices. The lack of coordination in wage-setting leaves firms more freedom to make adjustments and to react to economic change. But it also leads to a higher level of mobility among skilled employees. Differences of 40-50 % in the level of compensation received by employees doing the same job in different banks in the same local economy are common (Table 3).

These differentials leave wide latitude for firms to attract skilled employees from other banks by offering wage premiums. As the manager of one bank's mortgage lending group said, "In a bad business year turnover is pretty manageable, but in a good year our lender's leave in droves to go to competitors offering more money." In the wholesale lending segment, executive search agencies contribute to rapid turnover, with middle-market lenders reporting constant calls from headhunters. The result is a high annual turnover rate among commercial lenders. Interviews with the banks we spoke to suggest that the turnover rate is about 33% annually.

Poaching creates strong disincentives for firms to invest in training. An illustration of the problem is the failed attempt by a consortium of the largest New York banks to create a program -- modeled on German dual system of apprenticeships -- to comprehensively train young school-leavers in retail banking skills illustrates the problem. The program was set up in the mid-1980s to help these banks develop qualified individuals for their branch offices. It had a brief life, however, because high levels of turnover among the trainees made it impossible for banks to recover their investment of time and resources. Over 80% of trainees left their firm within a year or two, often to another New York-based financial service firm not participating in the program.

Poaching has also made it difficult for bank's to operate training programs for their commercial lenders. A comprehensive commercial lender course lasts about a year and can cost a bank $50,000 or more. Most banks would prefer to train their commercial lenders internally to instill their own lending culture, but often end up doing a large amount of their recruiting for these positions from competitors. Commercial lenders emerge from the training course with very marketable skills without having time to develop a strong attachment to their training bank, which makes it easier for a competitor to entice them away by offering higher wage.

Several of the banks we interviewed had recently cut back or stopped their lender training programs altogether owing to the problem of poaching. One Japanese bank had launched a major training program as part of its effort to penetrate the wholesale lending market in Los Angeles during the late 1980s. After losing 18 of 21 graduates from their first-year class and 19 of 20 in the second year, the bank shut the program down and soon became one of the most aggressive poachers in the LA area.

The cycle of poaching and counter-poaching not only discourages training investment, it also undermines attempts to build strong relationships with firm clients. High levels of turnover among commercial lenders makes it difficult create the level of trust and mutual understanding necessary for relationship-banking to work. As a result, bank's often find that their best competitive option is to earn profits on short-term business relationships.

Beating the Low-Skill Environment

More banks are realizing that in a highly competitive financial services market where banks are not the low-cost leader and product innovations can be copied rapidly, focusing solely on price and transaction volume may not be the best way to achieve competitive. Chase Manhattan Bank is moving towards facilitating cross-selling by leveraging information across product groups.[24] Bank of America and Wells Fargo are both trying to make headway in community lending by working flexibly with small business owners.[25] Achieving the shift to a relationship-banking strategy will only work, however, if banks restructure their human resource policies with attention to institutional constraints.

Two related human resource innovations hold out particular promise. The first is to create a new employment contract to motivate, develop and retain high-performing employees. This new contract has three elements: (i) competence-based career ladders for entry-level employees, (ii) modular training for high-skill positions and (iii) higher levels of internal recruitment in all positions (Table 4) . The second is to work with educational providers to develop courses that insure a higher level of skill attainment among entry-level recruits.

A New Employment Contract -- Banks used to offer some of the most secure jobs in the private sector. Deregulation, fierce competition and the accompanying waves of consolidation and downsizing, however, have put an end to the job-for-life. And yet if banks are to succeed at a relationship-driven strategy, they need employees that have multiple areas of competence and are able to actively solve customer’s problems. What is required is a new bargain between employer and employee, with banks offering continuous opportunities to develop and use new competencies related to career advancement in lieu of employment security. With layoffs spreading throughout the industry, those banks that offer this new bargain become relatively more attractive employers. One human resource executive expressed the new contract between employee and employer as follows, “We can’t promise lifetime employment, but we can give employees the resources they need to take control of their own careers."

Table 4: Alternative Human Resource Management Strategies

	Relationship-Orientation	*Transaction-Orientation*
Job Design	Broad job responsibilities Non-standard transactions	Narrow work tasks Standardized transactions
Training	Self-directed learning Modularized training program	Limited frontline training Front-loaded graduate training
Recruiting & Promotion	Competence-based career ladders Priority on internal recruiting	Limited upward mobility Heavy external recruiting

• **Competence-based Career Ladders**: A first step toward a new employment contract is broadening the responsibilities and improving the opportunities and incentives for skill investment among front-line employees. Banks pursuing a transaction-oriented strategy have taken the institutional constraints of low-skilled recruits and high turnover as a given, and sought to build service strategies around narrow jobs filled by interchangeable employees. In contrast, both Citibank and First Federal have sought to align their HR practices with a strategy focused on building customer relationships. They have constructed competence-based reward and promotion systems to broaden the skills of branch employees and lower staff turnover.

As in other banks, entry-level recruits receive a short introductory training designed only to prepare them for their immediate job tasks. But in the case of these two banks, motivated employees have the opportunity to enroll in on-going training modules to prepare themselves for upward advancement. The decision on whether to participate in on-going training classes is left to individual employees, but the banks try to make clear how the completion of training courses link to opportunities for advancement into different branch positions. As one Citibank executive said, “It’s up to the employees to take the initiative in developing these skills, but the bank has an interest in helping employees make more informed choices.”

• **Modularized Training for High-Skilled Positions:** Another part of the new human resource strategy to combat the effects of the institutional environment is the shift toward modularized training for high-skilled positions. If the problem for lower-level bank employees has been too little training and career development, the reverse has been the case for graduate training programs. These programs often involve a heavy up-front investment and long periods of unproductive time spent in the classroom. In a labor market environment with high levels of poaching this type of training program is generally not cost-effective. A long period of initial training leaves new recruits with very marketable skills before they have developed a strong attachment to the training firm, making them easy prey for competitors that have not invested in training programs.

An alternative way of meeting skill needs for high skill positions to take an iterated approach to training by alternating skill development with work experience. As they have moved to bring investment and insurance products into their branch offices, both Citibank and California Federal Bank have adopted a modularized training program for their high-skill branch employees. Rather than spend several months in the classroom, Citibank's all-around banking officers have a few weeks of introductory training on products and services. This period of introductory training is followed by the opportunity to enroll on an as-needed basis in training courses which cover investment and consumer credit products. Personal banking officers at California Federal Bank can enroll in one course after another to earn the licenses needed to sell progressively more sophisticated investment products. After completing courses on money market funds and life and disability insurance, personal bankers spend several months working before returning to take classes on mutual funds and annuities. They then have another period of work experience before returning to take the course they need to become a certified broker.

The modularized training programs in each of these banks are geared implicitly towards individuals with longer employment tenures. An employee picks up more skills the longer they work for the firm. This approach to training has two advantages for banks. Employees do not spend unproductive time in classes to learn skills that they will not immediately need. Moreover, modularized training also mitigates against poaching. Employees increase their skills at the same time that they are developing a stronger attachment to their employer.

• **Priority on Internal Promotion:** A third essential element of the new employment contract is a shift toward more internal promotion. As a natural response to the difficulties they have experienced retaining their own trainees, most banks rely heavily on external recruiting for high-skill positions. External recruiting is, nevertheless, an imperfect solution. It leads a bank's existing employees to see their own chances for upward mobility blocked, encouraging them to look to the external labor market in search of opportunity. Those that have been poached from competitors, meanwhile, have little reason to feel loyalty to their new employer and are likely to leave as soon as a better opportunity presents itself.

A different approach to recruiting and promotion can be found in innovative banks like California Federal, Harris Bank, Citibank and First Federal. As an extension of their commitment to stronger career paths, all four banks rely more heavily than their counterparts in the banking industry on internal recruitment for high-skill positions. While they do not promise their employees job security, they have made a commitment to meeting their skill needs internally, looking to the external labor market only when their are no qualified individuals within their own organization. California Federal Bank and Citibank both recruit close to 60% of their branch-based investment advisors from their own new accounts personnel, while 70% of First Federal's supervisors and personal financial officers started at the bank as tellers. Likewise, to fill its commercial lender positions, Harris Bank draws almost exclusively on its own pool of credit analysts rather than recruiting MBAs or competitor's lending officers. To allow its credit analysts to build their knowledge of business and market dynamics, it will send these individuals back to school to earn an MBA while they continue to work for the bank.

Stronger internal labor markets support the shift to a relationship banking strategy in two ways. First, it means that employees in high-skill positions know the bank, its products, and its customers. Second, stronger internal labor markets help reduce turnover. The belief that there are clear opportunities for upward mobility encourages employees, even those in the part-time branch-level positions, to stay on with their present employer. Internal placement also means that banks are promoting individuals which have demonstrated a commitment to their present employer. Creating clear career paths for all employees even its part-time tellers has helped First Federal Bank to reduce its employee turnover to 7% or one-fifth of the market average. Developing a strong internal labor market for high skill positions has helped Harris Bank keep commercial lender turnover under 10% annually or less than a third of the industry average.

Cooperation with Education Providers

In addition to restructuring internal human resource policies, a second, complimentary strategy for overcoming the effects of the institutional environment is to enter into cooperative arrangements with local education providers. The basic product knowledge and technical skills banks require from their new employees are common to the banking industry as a whole. All commercial lenders need to learn about finance and accounting, credit and risk analysis, and industry structure. Similarly, retail employees in all banks learn about the same basic deposit, checking, investment and credit products. Typical of the bank managers we interviewed was one who noted that the "core products employees must learn are the same from one bank to the next...banks compete not by changing the products but by changing interest returns." The prevalence of poaching provides additional evidence for banks' common skill requirements. The skills learned in one bank are often easily transferable to another.

The generic nature of many skills needed for employment in the banking industry creates the potential for mutually beneficial cooperation between banks and two- and four-year colleges. For educational providers partnerships with banks can help them to better prepare their students for employment in a volatile labor market. Given the high level of restructuring in the financial services market, new labor market entrants need skills that can be transferred from one financial service firm to the next. Since a large number of banks hire college students on a part-time basis while they complete their studies, the education-bank partnerships would just need to take the extra step of linking work experience more directly with course content, as is done in cooperative education programs in other economic sectors.[26]

For banks, working with two- and four-year colleges to prepare students for a career in banking allows much of the cost of general skill development to be externalized. Banks focusing on a relationship management strategy need employees with broad and general skills, but given the problem of poaching cannot afford to develop these skills at their own cost. By encouraging colleges to develop courses directed at the financial service industry complete with business cases on applied finance, risk analysis, investment strategies and other technical subjects, and then making completion of these courses a condition of hire, banks can fill their high-skill positions in both retail and wholesale banking at a much reduced initial training cost. Banks will need be to provide training only on bank specific products and procedures to complement general skills learned during school.

A bank that has worked to establish a cooperative training course has no guarantee that those completing the training course will come to it for employment. Like the training courses that banks run internally many of the course graduates will go onto other financial service firms in search of employment. The main advantage of the educational cooperative is that most of the costs of initial training will be paid for by the school, the students, and their parents. Banks will not need to pay a trainee's salary while they are enrolled in classroom-based training. Living expenses during the training period will be paid by the student or his or her parents. Instructors' costs and most course development will also be paid for schools. The only expense incurred by the bank is the time spent by its human resource personnel working with schools to align course content with business needs.

Educational providers have been quicker to realize the potential benefits of this cooperation. Recognizing the need to help their students generate broad and general skills, schools and colleges in San Francisco, Los Angeles, Chicago, and New York have all attempted to set up courses targeted at the financial services industry. The main barrier to making such cooperatives work has come from the banks' side. Our interviews suggest that banks, even more innovative banks have failed to move beyond their traditional arms-length relationship with educational providers. In taking this hands off approach to what young people learn in school, banks have missed a tremendous opportunity to cost-effectively improve the overall skill levels of their new recruits.

Conclusion

While the dynamics of competition are clearly different from one service sector to the next, the challenge of providing higher quality outputs through integrated and customized service delivery is common to firms across the service economy. From retail businesses to insurance and hotels, American service firms are trying and often failing to tailor their services more closely to customer needs. As we have suggested in this article much of the explanation for this failure stems from the interaction between managerial decision-making and the institutional environment. Constraints imposed by the American labor market environment make it easier for service managers to focus on cutting costs than to focus on adding value. Low levels of skill formation among school-leavers and the endemic problem of poaching both make it difficult to base competitive strategies on customized and integrated service delivery.

Banks and other service providers, however, can go a long way toward overcoming these institutional constraints by reforming their human resource policies and practices in the ways we have outlined. Working with educational providers to smooth the school-to-work transition will allow firms to realize a higher level of skill in the labor force at a lower cost. And a new employment contract that features modularized training programs, stronger career paths in all positions, and more internal recruiting will encourage broader skill formation lower levels of employee turnover. Together these innovative human resource practices can make it much easier to meet the emerging quality demands of their customers.

Footnotes

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[7] All data on private holdings from the *Statistical Abstract of the United States*, Flow of Funds Accounts--Assets and Liabilities of Households: 1980 to 1992 (Washington D.C.: U.S. Department of Commerce, 1992), p. 506.

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[11] This phrase came out of a conversation with Jeffrey Pfeffer.

[12] B. Keltner "Comparative Patterns of Adjustment in the U.S. and German Banking Industries: An Institutional Explanation," Unpublished Dissertation, Stanford University, 1994: Table 3.1.

[13] "American Banking: Roped Together," *The Economist*, October 28th, 1995: 92; R. Hylton "Merger Mania and Fat Profits Make the Big Banks Look Good," *Fortune*, August 7th, 1995: 259-261.

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[15] Bureau of Labor Statistics, Public Use Microsamples of the Census, 1980 & 1990; own calculations

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