# PLANNING ASSUMPTION



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# Joint Ventures in the Financial Services Industry: Failures, Fables and Foibles

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## Giga Position

The financial services industry has been faced with many challenges: increasing competition from nonregulated entities, deregulation in many countries, globalization, mergers and acquisitions, industry consolidation and the heavy investments this industry must make in technology to remain competitive. Many companies in financial services have responded to these challenges by pooling their resources via industry-led consortiums and, more recently, joint ventures (JVs). The explosion of the Internet as an alternative delivery vehicle for their products and services has only increased the level of investment in technology required to remain competitive. As a response to this ever-expanding technology budget, financial services firms have dramatically increased the number of joint ventures they have invested in during the past three years. Unfortunately, very few of these deals actually deliver promised benefits within the time frames estimated by the parties. The costs of failed joint ventures run into the billions of dollars, both in terms of real capital costs and the lost opportunity costs financial services institutions incur when their time and attention is focused away from their core businesses.

## Proof/Notes

Why do financial services companies invest in joint ventures if the risk is so high? There are multiple reasons a company might enter into a joint venture. Understanding the business motivations behind a company's decision to enter into a JV is key to outlining actions for success. Those business reasons are outlined below. Also, although less of an issue since the slowdown in the US economy, the valuation of a financial services firm that participates in joint ventures with the potential to generate additional fee income is typically higher (upward of 10 percent to 15 percent higher in a strong economy) than that of financial services institutions that do not participate in joint ventures. The financial community views such business structures as a way to mitigate the risks associated with new technology developments by sharing those risks with other firms, and that changes the market perception of some firms that may have previously been viewed as not innovative enough or without the ability to expand beyond their own geographic territories.

### Reasons to Invest

The following are business reasons that financial services companies invest in joint ventures:

1. *Increase market share*: As companies move aggressively beyond their own borders, one of the most successful (and least expensive) ways to enter a market in another country is by partnering with a firm already established in that country. Local laws, business relationships, supplier relationships, tax implications and brand-name recognition are all hurdles that must be overcome for a company to do business successfully outside its own borders. In some countries, such as China, just obtaining a license to do business can take years and substantial investments with government agencies. To defer some of the costs associated with establishing a company's brand name and distribution network in another country, companies like **John Hancock** have entered into joint ventures (this one, a 50-50 ownership structure with **Tianan Insurance Co.** in China to offer insurance to the China's 1.26 billion people). In

these types of JVs, companies partner with each other to gain access to markets that may be cost-prohibitive or too time-consuming to enter on their own. These arrangements can be quite lucrative. **Liberty Mutual Insurance Co.**'s international division, composed of subsidiaries and joint ventures, has more than 5,000 employees in 15 countries that contributed approximately $2.1 billion (15 percent of the company's total revenues) to the bottom line last year. The company plans to grow this division to 25 percent of total revenues in the next two to three years.

Not all JVs of this sort, however, are structured to allow entry into a new country of operation. In many cases, companies agree to market each other's products and services jointly. In March of this year, **Zurich Financial Services** (ZFS) and **Bank of Scotland** (BoS) teamed up in a joint venture that allows ZFS to offer its customers banking services and loan products, while BoS gains access to ZFS' distribution network, which is composed of a newly developed Internet portal, a 4,700-person sales force and access to ZFS' 4.5 million customers. Each company is leveraging the advantages of the other, reducing risks and expenses for both.

2. *Develop new technology*: This is a particularly popular reason for financial services companies to enter into JVs, instead of the less restrictive (and less binding) "alliance" arrangements or partnerships. Under this scenario, companies that are looking to spread the risk associated with gaining access to new technology would each make an investment of capital, perhaps people and, in some cases, technology, to develop new technology products or platforms. In some cases, such as the JV between **Bank of Montreal**, **Barclays Bank PLC** and **New Zealand Banking Group**, called Proponix, these financial institutions partner with one another to introduce new platforms to the marketplace. Proponix plans to offer online processing of complex international transactions, such as letters of credit guarantees, by allowing customers to apply for letters of credit at their local bank's Web site, then using the Internet to ship that information to Proponix for processing and tracking. The financial risks associated with development of a new system is shared among the participating banks, as is the potential fee income the JV would generate once other financial institutions begin to participate. Increasingly, however, institutions are not only partnering with each other but are also aggressively pursuing partnerships with leading technology companies like **IBM** and **Microsoft**. Viewpointe Archive Services is a joint venture between **Chase Manhattan Bank**, IBM and **Bank of America** aimed at introducing technology to the financial services industry that captures and stores digital images of checks and check-related items as they are processed and cleared. The parties hope Viewpointe will be another step along the road toward creating a national check image interchange that can be accessed by member banks and their customers, reducing an estimated 30 percent of a financial institutions check processing costs. Last year, **Wells Fargo & Co.** and **Citigroup Inc.** partnered with **Enron**, **S1 Corp**. and **i2 Technologies** in a JV called FinancialSettlementMatrix.com (FSM). FSM was formed to introduce payment-processing technologies to the Internet business-to-business (B2B) marketplaces. The participating companies each contributed equal amounts of equity to the arrangement: Enron contributes its broadband network, and i2 and S1 each have licensed their software to FSM.

3. *Challenge a competitor*: In some cases, financial institutions develop joint ventures solely to challenge a market leader or become a market leader. Although **CheckFree Corporation** (CF) is the leading vendor in the electronic billing and payment processing market (EBPP), in 1999, Wells Fargo, **J.P. Morgan Chase** and **First Union** joined together to create Spectrum Venture. Spectrum is meant to allow these financial institutions, which among them have more than 65 million customers, to seize a key position in the relationship with its customers and other businesses that are being challenged by companies like CheckFree and **Transpoint** (which was purchased by CF last year). The effort to create a new company was based on the fear of both the monopoly hold CheckFree had on the EBPP market and the fact that these banking institutions (and the more than 20 smaller banks also participating) are being increasingly placed further and further from the end customer, leaving them in the potential position of losing lucrative fee income. Of the top 50 banking institutions in the world, fee income represents between 30 percent and 40 percent of total income, so the concerns associated with the loss of this revenue stream are very real. Additionally, as e-commerce matures, payment processing will be a key component of any

financial institution's services offerings. In the case of BillingZone, (a joint venture between **PNC** and **Perot Systems**, they recognized the migration of EBPP from consumers to corporations and have collaborated to offer an electronic invoice presentment and payment (EIPP) solution.

4. *Commercialize internally developed products*: Financial services companies have led all other industries for the past several years in technology spending. As a group, these companies spend an average of between 11 percent and 15 percent of total revenues on IT. Much of that spending has gone to develop customized systems, in-house, to manage their business challenges. Increasingly, financial services institutions are looking to leverage those investments by taking their internally developed solutions to the general market and trying to sell these products. Almost all of these companies lack the market presence, skills, sales and marketing, and support staffs required to package, price, deliver and support commercial software, so increasingly they are establishing joint ventures with technology firms that do have the infrastructure and experience to market and support commercial software. Bank of Montreal has been one of the financial services leaders in this area. The bank announced at the beginning of this year yet another joint venture — this one with **724 Solutions Inc.** that will offer wireless services and support to smaller and midsize financial institutions in North America. By leveraging investments and experience the bank had garnered when creating its own wireless infrastructures and services, and combining that with 724 Solutions' services, which had only been targeted at large banking institutions, Bank of Montreal expects to enter the wireless services markets early and establish a position of dominance with smaller institutions. In 1998, Bank of Montreal teamed with **American Management Systems** to launch Competix.com, which offers instant credit decisioning to smaller banks that the company had codeveloped with AMS. The bank also created FinancialLinx with **Newcourt Credit Group** to provide auto-leasing services to dealers in Canada. **State Street** developed FX Connect internally, then offered the service to other banking institutions via a partnership that includes **Commonwealth Bank of Australia**, **National Australia Bank**, **Westpac Banking Corporation**, **Deutsche Bank** and **ABN Amro**. These types of joint ventures aim to leverage the core capabilities of each company to capture market share and generate new revenue streams, while accelerating the return on investment (ROI). (For more information, see IdeaByte, Bank Collaboration: Trying Yet Again, Now With Foreign Currency, Penny Gillespie.)

### Why Joint Ventures Fail

Given all of the business reasons cited for creating joint ventures, why do so many of them fail?

1. *Organization structures*: The larger companies in these deals dominate many of the joint ventures announced in financial services, essentially denying smaller companies a voice in how these businesses will be run. Although you could argue that larger companies have probably contributed the most money — and therefore should have a stronger representation in the board or management team, this kind of organization structure often alienates the smaller institutions and leads to defections. We also find some of these JVs managed by principals from the participating firms, who take on JVC responsibilities in addition to their existing responsibilities. For joint ventures to succeed, they must have a full-time, dedicated management team, whose sole responsibilities are the day-to-day management of the new company. Additionally, when these JVs are formed, organization structures, hiring and recruiting, reporting structures and representation are all issues that must be decided on before the company is formed, and it must also be documented that all companies considering whether or not to invest in the JV clearly understand how the new entity will operate, where their own individual influence and representation will occur and how the new company will report to its partners. Alternatively, however, one of the main reasons JVs fail is due to large, unwieldy management teams that get bogged down in corporate politics and cannot make a decision. For example, a board managing Integrion — a joint venture created in 1996 by 17 member banks — allowed each member to have a seat. This led to an organization that spent more time arguing than getting anything done, since each of the member banks lobbied for solutions that met their individual needs, rather than solutions that were the best fit for Integrion as a whole. A balance must be struck between representation and efficient management

structures for large JVs to function well. One of the most successful strategies we have seen employed has been with JVs that hire outside executives, who have no connections to the member firms, to manage the efforts, and the hiring of outside board of director members who can ensure the JV remains politically independent.

2. *Politics and infighting*: Nothing will seal the fate of a JV quicker than politically motivated management teams, a prime factor behind the very public failures of so many of the B2B marketplaces formed by other industries. Did anyone really believe that **Ford Motor Co.**, **General Motors** and **DaimlerChrysler** would ever agree on anything that might give a competitor an advantage? It is here that the most difficult challenge for a joint venture lies. Those participating companies must be willing to be open and honest when dealing with each other and must be willing to put their individual needs aside in favor of the needs of the joint venture. A daunting task, to be sure, since many companies become extremely concerned that information disclosed to the JV about operating practices, products, research and development (R&D) efforts, etc. may cause them to lose competitive advantages and market share. This notion of coopetition — cooperation and competition — is one that is extremely difficult to master. When companies are reviewing joint ventures that would cause them to disclose proprietary information to a competitor, they must go into these arrangements with open eyes and plenty of legal advice, since it is not only during the joint venture that privacy concerns are paramount; even more importantly, how do these same companies protect their intellectual capital if the JV fails? We strongly advise companies that are considering JVs with competitors that would force them to disclose key operating strategies to consider their decision very, very carefully. Remember that employees of companies change, management of companies change and the "friend" and colleague at a competitor today may, in fact, not be in the same position tomorrow. We believe JVs that require many competitors to participate under conditions where their individual company intellectual capital may have to be disclosed have a high likelihood of failing, with potentially disastrous consequences. Carefully consider the members of the JV before incorporating, outline the privacy considerations and protections early in the process, ensure outside representation and craft legal agreements with substantial penalties that would force competitors to think twice before damaging a colleague. Finally, understand that participating companies must assign employees to work in a JV who have a long history of cooperation and experience with multidisciplinary project teams and who are willing to put their (and their companies') individual needs aside for the good of the joint venture.

3. *Biting off more than you can chew*: While the formation of Spectrum Venture was admirable, this joint venture was attempting to overthrow a market leader (CheckFree) that had established technologies, market share, name brand and experience. (They were also trying to do this without real leadership, since Spectrum had an acting CEO who had responsibilities outside Spectrum. It was only somewhat recently that Spectrum hired a dedicated CEO.) Not only a daunting task, this is next to impossible. For JVs like this to succeed, they *must* obtain the participation of the majority of leaders in a market segment. In this case, although Wells Fargo, J.P. Chase and First Union are market leaders, Bank of America and Citigroup refused to join, and, to add insult to injury, Bank of America recently became a major investor and participant in CheckFree. The reasons companies either defect from a JV or choose another option are simple: They see their decisions whether or not to participate as fundamentally competitive choices. Bank of America viewed participation in Spectrum as giving up a competitive advantage, increasingly more important as many of these institutions begin competing in the same geographic markets via the acquisitions that are taking place. It is highly unlikely the Spectrum Venture will have enough capital to continue to enhance the EBPP technologies to compete effectively with market leader CheckFree. And, if features and functions of the bill payment and presentment software tools cannot keep pace with industry leaders, then these institutions will clearly be losing competitive advantages. One of the most common problems plaguing JVs in the financial services industry has been their inability to get to market quickly with new products and services. This, we feel, will be Spectrum's most significant challenge going forward.

Companies that create JVs solely to challenge a market leader must have the size, scale and financial commitment necessary to adequately compete. These JV participants also need to commit to the joint venture for the long haul, at least five or more years if new product development is at the heart of the JV, since it will take at least that long to create, market and support a stable product. Those that cannot commit to longer time frames and capital expenditures are better off not participating.

4. *Standards, standards, standards*: Many of the technically based JVs that introduce new products and services to the marketplace are predicated on the fact that the JVs will be able to force new standards that, of course, will be adopted industrywide. This is not the reality. The chances of success of any joint venture that must establish industrywide standards are slim and none, since so many forces aim to directly thwart the efforts of the JV. Competition from other market leaders, competition from technology companies and the sheer time and monumental effort involved to create, document and obtain consensus for new industry standards almost preclude any efforts by companies that are attempting this herculean task. The only exception to this might be the convergence of the Open Financial Exchange (OFX) and Gold standards, thanks to the Integrion joint venture, which initially was composed of IBM and 17 member banks. (The membership was later expanded to include **Visa** upon the Integrion acquisition of Visa Interactive.) The JV was based on a product built by IBM using a new standard for online banking known as Gold, which competed with OFX (a protocol previously established to support PFMs). Today, the OFX and Gold standards have converged — to a large degree — in the new Interactive Financial Exchange (IFX) standard (see IdeaByte, Open Financial Exchange or Interactive Financial Exchange — What Should One Be Using? Penny Gillespie; and IdeaByte, Open Financial Exchange (OFX) Downloads: A Better Approach to Financial Data Aggregation? Penny Gillespie).

   The success of FinancialSettlementMatrix.com will be predicated on the company's ability to create standards around its set of product offerings. Again, when companies are evaluating whether or not to participate in or launch a joint venture, the issue of standards must be considered. If the market into which the JV will introduce its products or services is already swamped with competing standards and infrastructures, it is highly unlikely a JV will solve that problem. However, if no standards exist, JVs can work effectively. The credit card industry would not be the multibillion-dollar market it is today without the formation of Visa and **MasterCard** — cooperative efforts by member institutions that were able to craft standard schemas that were adopted industrywide.

5. *In-house solutions do not make products*: Financial services companies have invested multibillions of dollars over the years creating their own software suites. Many of them have felt that these complex systems would undoubtedly earn them millions of dollars if sold to the outside market. Unfortunately, what many of these companies fail to realize is that the customization that ensures the systems meet an institution's needs exactly is precisely what may prevent a product from being broad enough to appeal to other companies. Software must be generic enough to satisfy the business process demands of many companies, and therefore not every product will be "vanilla" enough to sell on a broad basis. Unfortunately, we have seen instances where technology companies have taken advantage of this situation, preying on companies' egos by offering to support and sell the product to the outside market and split any revenues associated with such a sale, if — and only if — the developing company is willing to bear all (or most) of the expenses associated with making the product generic and willing to sign a long-term services contract with the technology vendor. We also find the same challenges with collaborative solutions that are created by these joint ventures among members of the financial services companies and technology vendors. The lure of creating systems and technologies that leverage high combined transactional volumes of the participants in order to lower the cost per transaction is what initially attracts many of these companies to these joint ventures. However, for any of these collaborative solutions to appeal to wider markets, these companies must be able to separate the "commodity," the leveragable portion of any of these solutions, from the ability to customize them. It is only when these solutions are designed so that companies can add their own differentiation to the core application that there will be wider market acceptance of these solutions.

In these situations, the technology vendor bears very little risk and gets a long-term services contract with the sponsoring company. Any company wishing to productize an in-house developed system, or a collaboratively developed solution, should employ the services of an outside agency that can truly, and objectively, estimate the costs involved with making a product commercially viable, the risks associated with such an alternative, the market potential for the sale of such a product and the pricing/revenue estimates necessary for any firm in this position to make an informed decision.

## Alternative View

Joint ventures in the financial services industry can succeed if the companies involved plan carefully, obtain qualified legal counsel, understand clearly the business goals of the joint venture (ensuring that the JV objectives do not conflict with those of the investing company) — and document those goals and associated timelines — and take appropriate steps to mitigate risk. Although the industry has been plagued with consortiums, alliances and JVs that have failed to deliver business value, it also has had some spectacular successes as seen by Visa and MasterCard and the introduction and market acceptance of automated teller machines (ATMs).

## Findings & Recommendations

Companies considering joint ventures should observe the following carefully:

1. Investigate the organization structure, governance, reporting and sanctions for members that break the rules of the JV before engaging in an agreement. Management structures should comprise full-time executives who are dedicated to the joint venture; the structures will be enhanced if outside, objective management experience is sought and employed. Decision-making should also be clearly defined and documented, since lags in decision-making are one of the key reasons JVs fail to get to market quickly, resulting in failures.

2. Ensure that the participants in JVs, who are representing their own companies — perhaps as board members — also manage the expectations of constituents within their own companies in regard to the JV. Failure to do so will result in dissension among the JV supporters. JV board members must manage both upward and downward, setting appropriate expectations among all of the constituencies they serve: clients, prospects, investors, employees and their own executive management structures.

3. Explore the issues surrounding standards in-depth. If the technology to be introduced is predicated on industrywide adoption of JV created standards, there is a high likelihood of JV failure. Rather, companies should reduce risk by employing as many existing standards as possible.

4. Obtain outside, objective reviews of in-house developed systems and their overall market potential before approaching any technology vendor for potential partnerships. A clear understanding of the costs and commitments expected from a financial services organization before building a final business case will go a long way toward eliminating the “pride of ownership” issues that can sometimes cloud a company’s judgment on the viability of any technology and associated market acceptance.

5. Understand clearly and document the legal, tax, employment and distribution issues prior to any decision to enter into a JV internationally. These issues are extremely complex and vary widely on a country-by-country basis.

6. Align the operating rules and objectives of the JV clearly with a company’s own internally accepted practice. This is particularly important if a company’s brand name will be associated with the JV, since erosion of a company’s image can occur if the JV’s method of operation is drastically different from the participants’ methods.

7. Ensure that when companies offer to contribute an employee’s time to a JV, the employees who are

participating are solely incented by the success/failure of the JV and not by the operating results of the parent company. For JVs to work effectively, companies must be willing to have their employees make decisions that are in the best interest of the JV, even if those same decisions are not in alignment with the immediate goals of the participating members. Exceptions, of course, revolve around preserving intellectual capital and company secrets. This area, in particular, needs to be clearly defined and the rules of engagement clearly spelled out to protect all of the parties involved.

8. Outline a specific, detailed business plan that contains milestones, timelines, resource and capital requirements and early deliverables that will ensure ongoing participation by the members of the venture. (Make the JV staff accountable for meeting milestones and deliverables.) Many joint ventures fail to deliver business value because the participants did not observe this step. Too many firms we reviewed failed to plan introductions of new technologies so that some working components of that technology could be delivered to the participants fairly early in the process. Long lead times for monster-size development efforts often leave members of the JV in a position of losing focus and attention — and leave the door wide open for competitors that may be more nimble to enter the market with competing products or technologies. It is very, very difficult to require participating members of a joint venture to contribute millions of dollars toward a development effort, then ask those same participants to wait two years for results. This lag in delivering working components has plagued recently formed JVs like Identrus and Spectrum. Even though the Integrion JV was based on an existing IBM Internet banking platform, deployment of the platform was excruciatingly slow, the governance structure of the JV could not make decisions quickly and Microsoft took advantage of this lag in delivery to create its own solutions that were brought to market. Integrion took its last breath in March 2000, leaving participants with very little to show for their investments. The three member companies that had installed the Integrion platform have abandoned it — millions of dollars and four years later.

9. Ensure the participating members of the joint venture have the commitment and the capital to continue their involvement in the effort. Two prior examples of failed alliances/joint ventures, Bankwire and EDIBanx, failed because of excessive capital demands that were placed on the members of the joint venture, according to Mark Sievewright, president and CEO of **TowerGroup**, a research organization focused specifically on the banking industry.

10. Outline what happens to the assets of the JV if the venture fails. This needs to be defined clearly, including policies on the distribution of any intellectual property created from the JV (who owns licensing and rights?), the disposition of assets and personnel policies. Consider the "divorce" before signing the "marriage certificate."

## References

### Related Giga Research

**IdeaBytes**

Bank Collaboration: Trying Yet Again, Now With Foreign Currency, Penny Gillespie

Open Financial Exchange or Interactive Financial Exchange — What Should One Be Using? Penny Gillespie

Open Financial Exchange (OFX) Downloads: A Better Approach to Financial Data Aggregation? Penny Gillespie

### Relevant Links and Other Sources

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