

HOW COMMERCIAL BANKS IMPLEMENT FINANCIAL INNOVATIONS- A CASE FROM RETAIL OPERATION OF THE BANK OF CHINA

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Abstract: The rigorous development of the market-oriented financial system has been witnessing the variety of China's commercial banks restructuring and stock exchange listings. Through the transformation process, Chinese commercial banks face two reformulations: 1) from the traditional business operation mode of the wholesale credit operations to a new integrated operation the wholesale and retail are now regarded as the twin engines; 2) from the traditional profitable model, which was mainly based on the margin between deposit interest and credit interests, to new profitable model which now includes non-interest incomes. This paper takes the retail business of Bank of China as the point of studying, through analyzing the innovation in business philosophy, management, procedure, product, promotion and technology, analyzes the reasons of innovation and objective restrictions. We try to construct a theoretical framework to illuminate the formation mechanism for financial innovation.

INTRODUCTION

Since Joseph Alois Schumpeter introduce "innovation" into economic analysis, economists and managerialists have been keeping their eyes on the form and content of innovation and its important function in economic development. As a main branch of innovation theory, financial innovation of commercial bank draws more and more attention from theoretical circles. Based on the "enterprise life cycle theory", Wencai Xue(2004) studied the balance issue between commercial bank's innovation power and control force. He said at present there are more tendencies of control than tendency of innovation, and in order to get the balance between them, commercial banks need to change operation target, operation model and the pattern of growth. Junming Huang(2006) and Fengqi Cao(2007) discussed the response of commercial banks under the context of financial innovation.

The rigorous development of the market-oriented financial system has been witnessing the variety of China's commercial banks restructuring and stock exchange listings. Through the transformation process, Chinese commercial banks face two reformulations: 1) from the traditional business operation mode of the wholesale credit operations to a new integrated operation – the wholesale and retail are now regarded as the twin engines; 2) from the traditional profitable model, which was mainly based on the margin between deposit interest and credit interests, to new profitable model which now includes non-interest incomes. The characteristic of such a change is the tremendous increase of retail operation and improved contribution rate within the bank. In addition, some valuable financial innovations have emerged.

The extant theoretical researches probe bank issues more from the macroeconomic perspective, but attach less importance to the micro-level of finance innovation, and investigate less into phenomena appeared during the rapid growth of retail operation. We find that unlike developed countries that focus on the innovation of financial instruments, Chinese commercial banks take on more innovations in operations management, such as operational philosophy innovation, management innovation, procedure innovation, product innovation, promotion and marketing innovation, and technological innovation. At present, more Chinese commercial banks think the most important thing to them is to accomplish the reconstruction of main parts of market players at micro-level, become the participator in a mature market which conforms to international governance standards. During this period, innovation should not be only took in the field of design and development of financial instruments, the key should lies in taking comprehensive and systemic efforts in many aspects, such as management, system, technology and product.

INNOVATION IN RETAIL OPERATION OF COMMERCIAL BANKS

With the deepening of the reform process, Chinese commercial bank's traditional business operation mode 'the wholesale credit

operations' has been changing, the ratio of commercial bank's retail business has been increasing. Take the Bank of China as an example, during 2006-2007, the growth rate of retail business was 250%, which was 2.5 times of the growth rate of wholesale business at the same period. One of the important reasons lead this change is innovation which includes innovation in business philosophy, management, procedure, product, promotion and scientific & technology.

INNOVATION IN BUSINESS PHILOSOPHY

With the rapid development of economy, people's living standard improve continuously, people's attitude to personal credit and financial management has been exchanging. Under this situation, bank's retail business has been becoming the potential profitable area. With the conscious of this, the Bank of China set up a series of personal credit product, including housing loans, auto loans, personal secured loan.

Financial innovation is the core of the strategic transformation of commercial bank. Commercial banks take the principle of demand-oriented and regard market as the centre. According to the customer characteristics and combined with the actual operation and experience, commercial banks take the difference pathway in innovation and development.

MANAGEMENT INNOVATION

According to the general law of bank development, with the rigorous development of the market-oriented financial system and the increasing competition, efficiency is regarded as a primary issue. Internal management model is one of the main elements to improve operating efficiency and establish competitive advantage. There are two forms of commercial banks management innovation: 1) a full-time comprehensive department is responsible for full-range of innovation, including co-ordinate planning and management, co-ordination among different departments and risk control. The classic example is Barclays Bank model. 2) special management group in main business department is responsible for studying and managing innovation within own department which is like model of Bank of American.

The management model used in Bank of China is just like a combination of those two models. Strategic development department in head office is in charge of the full co-ordinate planning and management of innovation. But in Corporation Banking Department, Personal Banking Department and Financial Market Department, there are special management group respectively.

PRODUCTION INNOVATION

Production is the link between banks and customers, also is the concentrated expression of bank's competitive power. Approaches to product innovation should begin with listening to customers. For example the Bank of China quickly identified two opportunities to improve the mortgage process in the ways that customers told them would be most important to customers: reducing the amount of paperwork required for a loan application and shortening the time it takes to approve a loan. Research showed that incremental improvements in convenience and speed wouldn't do the job for customers. Meanwhile, the Bank of China adjust the structure of liability product, change the main function of liability business from deposit-taking to account management and customer service, change from passive liability to active liability. Also the profit model is changed from earning the margin between deposit interest and credit interests to income of intermediate operating expenses.

TECHNOLOGICAL INNOVATION

Technology plays a key role in the performance of banks. Collaborating with hardware, software, telecommunications and other companies, commercial banks are introducing new ways for consumers to access their account balances, transfer funds, pay bills, and buy goods and services without using cash, or leaving home. Commercial banks established World Wide Web based online services, which allow banks to bypass subscriber-based online services and reach the customer's browser directly through the World Wide Web. The advantage of this model is the flexibility at the back-end to adapt to new online transaction processing models facilitated by electronic commerce and by eliminating the constricting intermediary.

INNOVATION IN PROMOTION

In the traditional retail business, the major business for bank's branch is to do liability business which limited the bank's integrated function. Now the commercial bank is trying to change this status. The new promotion method "Directed -to-customer" is a trial in Bank of China. It uses the own promotion group to get in contact with customer directly, understand customers' needs widely, investigate and hold first-hand information; based on the current customers, the bank commit itself to develop new clients.

THE FORCES OF INNOVATION IN COMMERCIAL BANKS

The intense competitive environment makes innovation become the key method for commercial bank to survive. Chinese financial market is facing the new open era, many foreign commercial banks are entering into the large and medium-sized cities, which have a wealth of financial resources and sound financial environment. This situation results in the new competition in the same business, the competition of attracting high-end customers between foreign and domestic commercial banks is becoming one of the main issues which cannot be ignored.

The reforms of turning state-owned commercial banks into joint-stock commercial banks and stock exchange listing take the business philosophy "maximize shareholder value" into the commercial banks' model of operation. This idea improves the awareness of competition and make the innovation becomes an important development strategy.

The deep development of financial reform is an important impetus for economic development. At present, the processes of interest rate liberalization and the mixed operation are ongoing. However to commercial banks, interest rate liberalization and the mixed operation means big challenge to traditional business philosophy, management model and promotion method. This challenge force commercial banks make innovation objectively. All of these result in the necessary innovation in commercial banks.

FORMATION MECHANISM FOR INNOVATION

There is no doubt that innovation will be the mainstream in the future competition among commercial banks. Rather than to make a decision whether to enforce innovation, the primary issue to commercial banks is to think about how to innovate. In another words, banks should decide what kind of innovation form and path commercial they should take.

Commercial banks innovation can be defined as own reforms based on the environmental changes at several levels, such as organization form, business philosophy. Those environmental changes could from both internal and external. External environment include financial regulatory system, macroeconomic environment and conditions of market competition. Among these, financial regulatory system is the institutional environment at macro-level, the more stringent the financial regulatory system is, the less possible of financial innovation will be, or vice versa. Macroeconomic environment is the basic of innovation, a steady macroeconomic is useful to develop innovation.

Besides, financial innovation is restricted by internal environment, such as operating system, ownership structure, human resource, enterprise culture. The operating system is the fundamental factors impact the commercial banks innovation. Autonomy in operation, responsibility for own profits and losses, and assumption of the risks are the necessary micro-foundation for innovation. Ownership structure adjusts the innovation through affecting the aim constraint and budget constraint of commercial banks. The quality and the reserves of human resource are effective carrier of innovation. Enterprise culture is the soft restriction for innovation. Usually, if enterprise has more risk bearing capacity, the more intense and the greater innovation it can take.

Obviously commercial banks' innovation is affected by both external environment and internal environment. To address this issue, we use following model:

$$I = f(X_1, X_2, X_3; Y_1, Y_2, Y_3, Y_4, \xi) \quad (1)$$

I=innovation model (include two dimensions: depth and breadth)

X=external environment (financial regulation system, macroeconomic environment, conditions of market competition)

Y=internal environment (operating system, ownership structure, human resource, enterprise culture, etc)

ξ =random factor (unpredictable political, economic, military transformation)

In a sense, model (1) gives the determining function of commercial banks' innovation. Although it is hard for us to do mathematics statistics about the inner relationship between those elements and innovation, and all elements we listed here may not include all elements which will affect banks innovation, this nonobjective determining function help us to understand the innovation at mechanism level. If put some random factor and indistinctive factor aside, we may be can hold this idea that X_1 , X_2 , X_3 and Y_1 , Y_2 , Y_3 , Y_4 determine the innovation behavior of commercial banks in some extent. The exchange of these elements will result in the change of commercial banks' innovation. Its practical significance can be understood like this: commercial banks should take dynamic innovative activities based on these elements. This is also the general theoretical significance of this model.

Due to the different external and internal environment for various commercial banks, there is no standard innovation model for all commercial banks. As the main body of financial innovation, commercial banks should analyze the internal and external influence factor carefully, take the initiative to explore the innovation model which is follow the principle of value maximization.

This process should always follow the differentiated thread, through accurate positioning for internal and external environment, explore and operate innovative model with own characteristics; generate the innovative system which includes product innovation, management innovation, risk management innovation and system innovation to meet the differential demands between internal and external environment.

CONCLUSION AND SUGGESTIONS

Innovation is a systems engineering, with the improving of the degree of openness, ability to innovation and the effect of innovation become the major elements result in the existential threat to commercial banks. Based on this special background,

through analyzing the innovation phenomena, this paper makes a trial analysis for reason and formation mechanism of commercial banks innovation.

Compared with the commercial banks in developed countries, commercial banks in transition remain the trace of planned economy, the dominant position of market is still not perfect, internal driving force is lack. Meanwhile, relative laws and regulations, technique and professionals in the existing cannot completely meet the development demand.

The specific reform should focus on the following aspects:

- Set up the new consciousness that innovation is the soul of enterprise culture.
- Select the correct innovation model which should accord with its own characteristic.
- Broaden innovation form and context in light of own actual situation.
- Handle variety of relations to pave the way for innovation. Those relations include regulations, operating strategy, risk management, performance evaluation, and service level.

In the financial innovation area, commercial banks need to build capacity on selected fronts. It includes the integration of financial innovation into current bank business marketing policy and the development of long-term marketing vision. However, it must be emphasized that there is also an important role for policy-makers.

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