

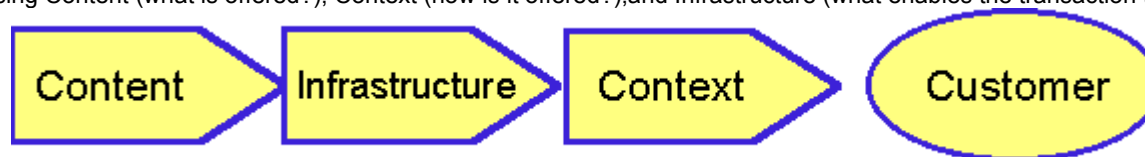


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VIRTUAL VALUE CHAINS

A NEW BUSINESS MODEL – THE VIRTUAL VALUE CHAIN

The virtual value chain, developed by John Sviokla of the Harvard Business School, is a simple but remarkably useful model for better understanding information-based industries. Industries involving physical goods operate through the familiar physical value chain (raw materials, production, distribution, marketing and sales) in a physical market place. Information-based industries – and financial services is almost entirely information based – operate in a market space, through a virtual value chain comprising Content (what is offered?), Context (how is it offered?), and Infrastructure (what enables the transaction to occur?), illustrated thus:



- ⌘ For a financial services operation, Content is the bread and butter of the business. It includes: services such as credit, or interest on savings, or advice; financial data such as account details; and, significantly, customer information. Successfully managing Content calls for qualities such as creativity, speed of development and, perhaps most importantly, trust. Most customers trust their financial institutions to act with probity, fairness and integrity and to maintain the security and privacy of their financial data. As we shall see, this reputation for trust is a tremendously valuable asset which can be leveraged to address other shortcomings.
- ⌘ Infrastructure corresponds to the institution's computers and networks, its back office operations, and the bricks and mortar of headquarters buildings and branches. Managing infrastructure is all about maximising reliability and minimising cost. Once again, financial institutions are traditionally good at this aspect of the business.
- ⌘ Context is a less familiar concept. Defined as the overall customer experience in any particular situation, Context combines elements of both Content and Infrastructure, embracing qualities such as levels of service and support, the look and feel of a particular interface, pricing, branding, and a host of other largely subjective qualities as experienced by a particular customer in a particular environment. Managing Context calls for obsessive attention to changing customer needs and behaviours, differentiation from competitors, and often working with partners to create a compelling packaged service offering. Most traditional retail financial institutions are poor at managing Context.

Content, Infrastructure and Context are superficially similar to Product, Delivery and Market respectively, but the concepts are broader and richer. Content includes not just the products themselves but also the information associated with these products and the customers who use them. Infrastructure includes not just delivery channels but the whole complex of information systems and processes which enable a transaction to be processed reliably and efficiently. By default, Context should equate to market, but clearly the concept is much richer than that, embracing not just a particular segment of consumers, but how individual consumers feel and behave in a variety of different circumstances.

By analysing a retail financial operation in terms of the virtual value chain, we may generate useful insights which are not otherwise immediately obvious.

- ⚡ The first point is that financial institutions, to be successful, must manage all three components of the value chain, and that this calls for three quite distinct sets of skills. We have seen that whereas financial institutions are usually good at managing Content and Infrastructure, they are often poor at managing Context.
- ⚡ But Context is arguably the most important part of the value chain since whoever controls the Context controls the relationship with the customer and this is the key to most retail businesses. Once upon a time financial institutions were very good at customer relationships, but for a variety of reasons - lack of attention to changing customer needs; overemphasis on cost cutting, economies of scale, and shareholder value; and insufficient attention to the core asset of trust - the relationship has been severely eroded.
- ⚡ Three types of non-financial companies are very good at managing Context - supermarkets such as Tesco, technology companies such as Microsoft, and strongly branded consumer companies such as Virgin (the financial industry as a whole is remarkably weakly branded). Not surprisingly, all these types of company are successfully challenging the franchise of the traditional retail financial industry.
- ⚡ This raises the familiar spectre of disintermediation – if customer loyalty migrates to skillful Context players, then financial institutions could be cut off from their customer base and reduced to the status of providers of commodity products, competing mainly on price.
- ⚡ The power of the virtual value chain becomes especially apparent in the world of the Internet and electronic commerce. Significantly, the companies currently making money out of e-commerce are mainly Context specialists. Companies such as AOL, Amazon, CD-Now, Yahoo, and Cendant (market capitalisation \$35 billion) own no Content and no Infrastructure but through a combination of ingenious technology and attention to their customers (or "members") have managed to create unique and strongly branded Contexts in a remarkably short time. A new term – "Portals" – has been coined to describe these Context specialists and they are currently the darlings of the US stock market. Such companies are increasingly turning their attention to financial services.
- ⚡ A feature of the virtual value chain is that it can be relatively easily disaggregated into its component parts. Thus one strategy for financial institutions may be to specialise on one component. Many insurance companies are effectively Product specialists, relying on a network of brokers and agents to distribute their product. Companies like Visa and Mastercard are good examples of Infrastructure specialists. There are few examples of Context specialists – American Express is a possible example – but with a little imagination this is by no means an unworkable option.
- ⚡ Another strategy may be to attempt to manage the whole of the value chain but to do so through strategic alliances. For example in the UK the Scottish banks have successfully partnered with supermarkets to address Context and an increasing number of institutions are outsourcing their IT and other Infrastructure components to specialist processing companies.

The various value chain strategies open to retail financial institutions are illustrated below:



- Become a content “factory”.



- Specialise in distribution or processing.



- Control the customer relationship.



- Control the whole value chain through alliances.

Interested? Please contact Nick Collin on nick@ncollin.demon.co.uk or +44 (0)207 833 8765 with comments or questions.

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