Bernardo Bátiz-Lazo

Direct Line Insurance and the Royal Bank of Scotland, 1985 to 1995: Technology, strategy and diversification

ABSTRACT:

Direct Line Insurance was born out of the diversification strategies of the Royal Bank of Scotland (RBS). Within ten years of its foundation it had become the first retail finance institution to establish a clear competitive advantage based on applications of information technology. Direct Line is best understood as a series of technological and competitive innovations that call into question the extent to which banks’ competencies must change to master alternative delivery channels to the «brick and mortar» retail branch. The success of Direct Line also highlights issues in the incursion of banks into bank-assurance and the development of a business model based on fee-income (as opposed to the traditional interest-income).

Introduction

The importance of technological change and particularly applications of computer technology to our understanding of the origins and evolution of the capitalist organisation is integral to the study of business history since the early 1990s. In this context there has been an increasing interest to map changes of computer technology within and around retail deposit taking. These contributions detail how, during the


2 As shown by pioneering studies such as Peter Wardley, The Commercial Banking Industry and its Part in the Emergence and Consolidation of the Corporate Economy in Britain before 1940, in: Journal of Industrial History 3 (2000), 71-97; Richard Coopey, Management and the Introduction of Computing in British Industry, 1945-79, in: Contemporary British History (1999), 59-71; Richard Coopey,
late 20th century, financial institutions engaged in a drive towards mass delivery of retail financial services and began a trend where more work was processed centrally and less at retail branches – with the subsequent loss of autonomy of the retail bank branch as a «self-sufficient production unit». The move from decentralised personal relationships to institutional managers was possible thanks to application of computer technology.

These changes date to the automation of internal processes during the late 50s and during the 60s. The computerization of internal processes together with innovations in products and services (e.g. credit cards), eventually led to the creation of electronic fund transfer systems (EFTS) in the 70s and 80s as intermediaries brought retail branches «online» at the same time that computers and computer networks were increasingly used for inter-bank payments. A key component of the replacement of skilled personnel at the point of contact with customers was the creation of relationship databases in the late 70s. This implied migrating customers’ records into electronic form as well as the creation of software (and underlying hardware) to mediate and give access to the tables and records for which a given user had been authorised. Applications of computer technology, therefore, promised higher organisational flexibility to those financial institutions that could effectively implement technical changes.

A second result of technical innovations that redefined banks’ business approach related to distribution capabilities. The branch network reduced its importance as the point-of-sale for financial services as new distribution channels were created, including electronic point of sale terminals, telephone transfer systems, telemarketing, direct mail, sales personnel relocated outside the branch (such as shopping malls and retail food stores), etc. New distribution capabilities aimed to exploit cross-selling opportunities to established customers (about whom financial institutions already had information).
These efforts included banks selling insurance-related products through direct mailing or through staff at retail branches; and insurance companies offering unsecured loans. Perhaps the most successful new delivery channels in the late 20th century were ATMs, telephone and Internet banking operations, which together with «brick and mortar» branches were the backbone of the multi-channel distribution network for banks based on an integrated customer account and computer system. However, not all substitutes of the bank branch enjoyed the same success: drive in/drive through windows, interactive TV banking, the Teleputer and the Minitel are all examples of long forgotten technology. Growth of the most sophisticated gadgets was often hampered by conflicts between retailers and banks as to the inadequacy of cash and cheques and also, as to who should receive the «lion’s share» of the profit.

The case study in this article adds to the growing literature on the computerization of retail banking by documenting a rare instance in which a retail finance institution established a clear competitive advantage based on applications of information technology (IT). From no established base, in ten years Direct Line Insurance increased the market share of British retail financial services of The Royal Bank of Scotland (RBS) while, at the same time, it grew to be the biggest direct motor insurer ever in the UK. This transition is best understood as part of a long chain of competitive, organizational and technological innovations in which the widespread adoption of a particular mode of delivering financial services did not follow immediately after its inception, nor did it necessarily appear inevitable ex ante. Instead it shows the co-evolution of technology and business culture. Elements of Direct Line’s performance depict the diversification of banks into insurance markets, how companies assimilated the use of information systems over time and more broadly, highlights the dynamics of how: «[a]ctions designed to exploit certain elements of the [market’s] structure will, in the process, transform the structure».9

The discussion is structured as follows. The next section presents a brief description of the history and characteristics of telephone-based retail financial services. The third section discussed the context in which the Royal Bank of Scotland explored opportunities in bankassurance through a telephone-driven subsidiary. The fourth section discusses in depth the origins of Direct Line’s success. The last section summarises how technical change (i.e. telephone-based operations) modified growth opportunities in bank markets and how technical change altered the stability of the environment, increased competitive pressures and called into question whether bank managers had control of core capabilities.
Telephone-Based Delivery of Retail Financial Services

Telephones were introduced to retail financial institutions early in the 20th century as part of the larger mechanization of retail branches. The telephone was primarily used as a means of internal communication. This was to change with the advent of computers and electronic data processing networks in the 60s. Business practices also evolved, and by the mid 1970s the telephone was seen as an important element of overall service delivery in European banking as a means of fluid communication with customers. Yet in the retail branch the telephone played a small part in service offerings. It was not part of any marketing effort and remained an item of mechanised office equipment until 1979, when distributing retail financial services through the telephone was unsuccessfully pioneered by Banc One Corp. of Ohio, USA. Despite Banc One’s experience, telephone-banking pilot schemes continued, and by 1982 telephone transfer systems were operational in a small number of Californian banks. In 1984, Sanwa Bank (Japan) was developing push-button-telephone interfaces while it already received 40 per cent of deposits and performed 70 per cent of card transactions through full online banking services. Also in 1984, Banamex (Mexico) launched a human-mediated telephone service to assist corporate clientele to manage funds and a second service that enabled retail clients to make enquiries and money transfers through a telephone conversation. These services were amplified in 1985 with the launch of the Audiomático modality, which allowed corporate and retail customers to carry out bank transactions and enquiries directly with a central computer through the combination of a dial-up telephone plus a touch-tone, card sized, mini-terminal.

In 1986, The Bank of Scotland and Nottingham Building Society jointly introduced the first major telephone banking system in Britain. Like in Mexico, the British system (called HOBs) aimed at home and office banking. HOBs was swiftly followed by TSB’s Speedlink system in 1987. A more advanced version of these systems was developed in 1989, when Midland Bank established a 24-hour telephone service under the separate identity of First Direct. This was the first British telephone-based, branch-less...
retail bank. The globalization of telephone banking, however, was rather slow. For instance, the first Canadian financial institution to offer an automated telephone banking service nationwide was the Canadian Imperial Bank of Commerce (CIBC) in 1992, and over one million customers signed up for the service by 1995.\textsuperscript{20} In Ireland the Bank of Ireland launched its Banking 365 service to 1996.\textsuperscript{21} This slow rate of dispersion was also evident in cross country studies, one of which suggested that in the USA transactions over the telephone represented 24 per cent of total transactions in 1995, whilst telephone-based transactions represented only four per cent of total transaction in the UK, three per cent in Sweden, two per cent in Germany and 1.5 per cent in France.\textsuperscript{22}

In spite of these apparent differences, banks in several countries reported a preference for electronic distribution. As early as 1985 in Mexico, Banamex’s internal estimates were that the average transaction cost per teller was 170 pesos, but over the telephone (speaking to an operator) it reduced to 90 pesos while the cost was 30 pesos (or less than a fifth when using a human teller) when employing the technology used by the Audiomàtico service.\textsuperscript{23} Although the magnitudes varied across countries and through time, there was consensus amongst the ranking of different delivery channels across several countries. Thus, for instance, in the year 2000 electronic delivery remained cheaper than using a human teller in the USA where the estimated cost of transaction in the retail branch averaged 1.07 US-dollars, one over the telephone 0.55 US-dollars, at an ATM was 0.33 US-dollars and 0.02 US-dollars over the internet.\textsuperscript{24} The adoption of computer applications thus promised dramatic effects in cost structures. These claims were further fuelled by contemporary anecdotal evidence. For example, there was a claim that Citibank (New York) was able to serve 85 per cent of its customers by telephone and electronically in the mid-90s.\textsuperscript{25} The same source stated that, for Citibank, automation represented lowering the overall cost rate from 70 per cent to 55 per cent with announced reductions of 30 per cent in branch staff costs.\textsuperscript{26} Changing from more to less expensive distribution channels was possible because the same information or transaction could be delivered in a number of ways. However, cheaper processes were an insufficient condition for reduced cost structures. For instance, providing an account’s balance costs less through an ATM than at the teller. But only if the total volume of requested balances remains unchanged will the total cost of ATM-supplied balances be less than that provided through branches. Technology, therefore, opened the way for banks to improve their cost structures, provided customers changed their behaviour according to banks’ expectations.

It is worth noting a trend underlying developments described above, namely the transformation in the use of analog telephonic technology to digital and smart net-

\textsuperscript{20}https://www.cibc.com/ca/inside-cibc/history/story-cibc-4.html [last access 20.7.2012].
\textsuperscript{21}http://www.bankofireland.com/about-boi-group/about-the-group/company-overview/boi-history/#doc_anchor2 [last access 20.7.2012].
\textsuperscript{22}Financial Times (3.5.1995).
\textsuperscript{23}del Angel, Computerization of Mexican Commercial Banks (cf. n. 16), 110.
\textsuperscript{26}Ibid.
works. In other words, a move from humans acting as both trouble shooters and network switch (by directing calls to their intended destination) to an infrastructure where the signal does not lose strength with distance (i.e. reproduced exactly as originated) and switching is fully automated and controlled by computers.\textsuperscript{27} This transformation resulted in a number of possible ways for financial institutions to interact with retail customers using a telephone and these, in turn, are depicted in Table 1 below.

\textbf{Table 1: Types of Interaction in Telephone-Based Retail Finance}\textsuperscript{28}

<table>
<thead>
<tr>
<th>Customer Interface</th>
<th>Bank Interface</th>
<th>Computer Interface</th>
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<tbody>
<tr>
<td>Person</td>
<td>The user speaks directly to the bank representative.</td>
<td>The user interacts with a voice recognition unit or uses a tone pad.</td>
</tr>
<tr>
<td>Computer</td>
<td>Computer managed access to required service specialist.</td>
<td>A computer or smart telephone interacts directly with the bank’s computer system.</td>
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Source: Author.

Table 1 illustrates four types of interactions to describe the way in which retail financial institutions and retail customers can interact over the telephone. Anecdotal evidence suggests that in the mid-90s most banks in the UK adopted the first way of interaction (person-to-person) or created two separate banking operations (person-to-person and computer-to-person).\textsuperscript{29} The type of application adopted was based on how managers wished to grapple with two important characteristics of telephone-based services. Firstly, services offered in the person-to-computer system were mainly high volume, standardised and relatively costly through the decentralised traditional platform (transactions such as balance inquiries, transfer between current account and investments, etc.). Secondly, those services that required more sophisticated responses and/or complete information were placed in the person-to-person system.

The underlying assumption of the person-to-person and computer-to-person approaches to telephone banking seemed to be that the human being remained the best machine to handle scripted queries. Using persons as final interface also allowed keeping the system’s growth opportunities (i.e. architecture) open while the number of options for interaction was computer managed. Under this strategy advisers take customers through a guided conversation (put on the screen by the bank’s system) and, in doing

\textsuperscript{27} Cortada, \textit{The Digital Hand}, (cf. n. 12), 485-487.
\textsuperscript{28} Robert Baldock, \textit{Clever Cats or Copycats} in: The Banker (1994), 91-93; Derek F. Chan-
non, \textit{The Strategic Impact of IT on Retail Financial Services Industry}, Imperial College, London 1996 [unpublished].
\textsuperscript{29} Ibid.
so, advisers retrieve all the information the bank actually needs to complete the cus-
tomer’s request through on-screen forms. Advisers don’t need to know why certain
data is vital, only that they need to follow screen-driven protocol. The system’s
growth opportunities remain open because system administrators can modify the inter-
action at will and without the need of major expenditures to retain or retrain the work-
force.

In summary and in spite of international differences in the embrace of computer ap-
plications, the success of new distribution channels enabled banks to reach a wider spec-
trum of customers, segment the established customer base into customer who had the
same purchasing behaviour, and reduce costs structures and increase fee income. But, at
the same time, this success consistently undermined an important barrier to entry into
banking, that is, the «brick and mortar» retail branch network. As long as it remained
the main distribution channel, the retail branch network was an effective barrier to
enter retail banking markets because potential competitors would have to invest heavily
to develop similar distribution capabilities. Banks realised that innovating distribution
capabilities also presented a threat because branches were no longer required for either
processing (as it moved to regional processing centres) or customer contact. The result
of technical innovation was that the same branch had potentially become a sunk (i.e.
irrecoverable) cost. Technological innovation forced bank managers to face the fact that
a vast branch web was a disadvantage for the future and rationalisation was necessary.
The challenge for bank managers was daunting because in the UK the last rationalisa-
tion process began with the amalgamation between banks of the 1870s. Since then and
for most of the 20th century, British banks consistently increased the number of home
and overseas outlets. However, nine per cent of UK retail bank branches disappeared
between 1968 and 1980. But approximately 2,000 or 13 per cent of the total were shut
between 1987 and 1992. In other words, the fact that access to a branch network
closed to be an entry barrier into retail banking meant that telephone-based operations
(with their low cost structure) could form a financial competitive advantage to new
entrants. Computer applications and especially telephone banking offered possibilities to
achieve high organisational flexibility and cost efficiency. Since depositary financial in-
stitutions did not control the intellectual property of this technology, telephone bank-
ing also opened the possibility for new entrants to contest bank markets while, at the
same time, banks’ «traditional» distribution channel became a sunk cost. The discussion
that follows presents these arguments in greater detail by illustrating how a UK bank
diversified across product markets and entered retail insurance markets through a tele-
phone-based subsidiary.

31 Timothy Morris, Innovations in Banking, Lon-
don 1986, 85.
32 Robert E. Morgan et al., Innovation in Bank-
ing: New Structures and Systems, in: Journal of
Scope of Bankassurance at The Royal Bank of Scotland

**Growth in Business Portfolio: 1980 to 1995**

Just as applications of computer technology moved from supporting payroll and financial reporting to supporting the underlying processing requirements of financial institutions (in trade processing, cheque clearing and policy issuance), so did changes in regulation in the 70s and 80s open up opportunities for diversification across the retailing of insurance and banking services. Particularly susceptible to new competition were motor and property insurance as the retail customer perceived them as "commodity products", meaning that their terms and conditions were pretty standard and purchases were susceptible to small price differences. These were not only the most widely purchased forms of property and casualty insurance, but to the USA it had seen the entry of low-cost, direct mail, highly-targeted advertising by direct underwriters that had eliminated face to face, sales agents contracts. In this context, the first European bank to make a direct challenge to insurance companies by selling insurance policies through its retail branches was Britain's Trustee Saving Bank in 1967. The Royal Bank of Scotland (RBS or The Royal) and many other European banks followed this diversification path as they sought to capitalise on cross-selling opportunities to the existing customer base. Bankassurance also promised to tap into new sources of fee income as well as leverage capital resources (by using retail deposits alongside insurance premium income to fund trading and investment activities).

The Royal's diversification into insurance began in 1985 with the establishment of «The Royal Bank of Scotland Group Insurance Co.». The aim of this subsidiary was to sell motor insurance, and it was subsequently renamed «Direct Line Insurance» in 1988. But bankassurance was not limited to motor insurance since RBS also established a joint venture with Scottish Equitable Life Assurance Society. This was called «Royal Scottish Assurance» and sold life insurance products through the branches of The Royal Bank of Scotland from 1990 onwards. Another subsidiary aiming to increase cross-selling opportunities was an independent adviser called «Royal Bank Insurance Consultants». This firm was established in 1991 to supply general insurance to both individuals and corporations.

The story behind Direct Line is noteworthy because, first, it «[...] was the first insurance company to [successfully] use the telephone as its primary sales tool, cutting out

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34 Ibid., 226.
37 The organization roots to developments in 1699 and subsequent royal charters in 1727 and 1738. At the end of the 1970s, what was to become The Royal Bank of Scotland Group had approximately 40 per cent of the Scottish banking market, 15 to 20 per cent of England's North West region and four to five per cent of the total UK market. Source: Ibid., 229.
middlesmen and commissions by selling insurance direct to the public.\textsuperscript{39} Second, its foundation and the entry of RBS into insurance came on the back of RBS rejecting hostile takeover bids by Lloyds Bank (1979) and HSBC (1981) as well as negotiations for a «white knight» takeover with Standard Chartered (1980) and a cross-share exchange agreement with Spain’s Santander (1988).

\textit{Direct Line Insurance: from Motor Insurance to Pension Funds}

By 1985 British financial circles had observed the performance of branch-less intermediaries (Girobank, established in 1968)\textsuperscript{40} and, as noted above, there was evidence of the possibilities offered by telephone banking (as pioneered by US banks). At the same time, overall use of the telephone as means of communication had risen in line with changing business practices. For instance in 1985 the telephone bill for Banco de Bilbao (Spain) was 20 per cent of operating expenses.\textsuperscript{41}

Direct Line started with 63 employees and 20 mn British Pound capital provided by RBS, a capital contribution which was increased in stages to 155 mn British Pounds in 1993 in the form of subordinate debt with no recourse to the parent company.\textsuperscript{42} But contrary to previous North American and British experiences, Direct Line’s business and margin rose rapidly between 1987 and 1993. By mid-1993 Direct Line’s overall strategy had captured approximately ten per cent of the motor insurance market. At this point, Direct Line had overtaken all the British composite insurance companies. In November 1994, 2.2 mn motor policies were in force. At the time, Direct Line employed 2,857 persons (around ten per cent of the total employees of RBS, its parent company). Growth from scratch to these numbers positioned Direct Line as the most successful motor cover provider and largest ever personal motor insurance company in the UK.\textsuperscript{43}

Figure 1 summarises the growth of this company and its network of links. It depicts how Direct Line grew in terms of regional centres and product lines, which included creditor insurance (1986), house contents insurance (1988), personal non-secured loans (1989), mortgage loans (1993), its own car repair centre (1994), income protection insurance (1995) and life (term) insurance (1995). This growth also illustrates Direct Line’s diversification from motor insurance to banking services (like savings and deposit taking).\textsuperscript{44}


\textsuperscript{39} Public Relations Department, \textit{The Direct Line Group}, Croydon 1995 [unpublished].
\textsuperscript{40} See further Mark Billings/Alan E. Booth, \textit{Techno-Nationalism, the Post Office and the Creation of Britain’s National Giro}, in: Bátiz-Lazo et al. (eds.), Technological Innovation (cf. n. 2), 155-172.
\textsuperscript{42} Archive Section (1993), \textit{The Royal Bank of Scotland: A Short History}, London 1993 [unpublished].
\textsuperscript{43} Direct Line Group, \textit{Annual Report and Accounts}, Croydon 1994.
\textsuperscript{44} A banking license was granted in 1995 and was initially used to sell investment funds in 1996.
Figure 1: Stakeholder Map for Direct Line Insurance, 1995

Source: Company reports; author.

Key: (X) = Year of acquisition (capital structure and organisation in 1995).

X = Year of establishment.

% = Per cent stake in financial capital.
even though computer applications and telephone distribution gave Direct Line the possibility of national operations right from the start, managers decided to concentrate in selected markets.45 Careful selection of geographic and product market growth built upon the brand name as key point for the firm to diversify products within the retail financial services markets. Growth at Direct Line leveraged on extensive use of marketing, accumulated experience and customer goodwill in a strategy that emphasised high levels of cross selling to an established customer base.46 The strategy, however, was not invariably successful. For instance, entry into mortgages and credit insurance had mixed results since both took longer to achieve critical mass than motor insurance. An important element in this product market move was whether to inherit on-going businesses from The Royal Bank of Scotland. The risk of building on the parent company’s activities was that the existing portfolios of customers contained more variety that Direct Line’s motor business. As a result the «[...] mortgage book for the bank and Direct Line was completely separate and continues to be. There was no cannibalism and the same applies to savings deposits.»47

Synergy and market positioning were the reason why separate franchises were kept, which allowed Direct Line to generate its own businesses. This is further illustrated in the following quote from a senior executive at the time:

«When Direct Line Financial services was created there was no risk to cannibalise. The bank had a small market share (about four per cent) [of mortgages and credit insurance markets], so Direct Line had 96 per cent of the market to grow. Second, as a group we expected to acquire more customers than through any single one institution.»48

In other words, managers at Direct Line used the bank’s business as a source of information to design their databases. Once operational, managers tried to keep separate and distinct activities. The decision to keep separate databases emerged from The Royal’s management board and aimed to focus each subsidiary on its core markets and core capabilities rather than a single institution attempting to establish a single sales force, which cross-sells all products to all market segments. Succinctly, managers of RBS aimed to keep organisational flexibility while they aimed to capture cost efficiency and integrate subsidiaries around strategic objectives.

_strategy for competitive advantage_

Financial Performance of Direct Line Insurance

The success of Direct Line has been attributed to the result of four distinctive forces namely: financial performance, innovative computer applications, focused marketing and quality service. Of these financial performance was the most important. Three fac-

45 Personal interview with senior manager of Direct Line, 30.11.1996.
46 Geroski, Market Dynamics and Entry (cf. n. 9), 163.
48 Personal interview with senior manager of Direct Line (30.9.1996).
tors created superior financial performance, namely the expense ratio, pricing policies and retention rates and the financial investment strategy.

Data in table 2 show that between 1992 and 1993 the expense ratio for Direct Line fell below 16 per cent. This was the lowest cost ratio among the providers of retail insurance. Direct Line’s low total expense ratios resulted from substantial scale economies, which emerged from its IT-based platform rather than from a labour-based platform. Direct Line was able to increase income and business volume without increasing labour costs (particularly between 1992 and 1993). As a result, between 1989 and 1995 business volume grew at an average annual rate of 31 per cent, while total expenses grew only at an average of 25 per cent per annum. This produced a steadily increased margin and a declining cost ratio.

Table 2: Relative Financial Performance of Direct Line, 1989 to 1993

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<tr>
<td><strong>Total Expense Ratio</strong></td>
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<td></td>
</tr>
<tr>
<td>Direct Line</td>
<td>30.15%</td>
<td>31.15%</td>
<td>26.21%</td>
<td>20.97%</td>
<td>13.77%</td>
<td>24.45%</td>
</tr>
<tr>
<td>Agency Writers</td>
<td>29.50%</td>
<td>29.50%</td>
<td>29.90%</td>
<td>30.20%</td>
<td>29.70%</td>
<td>29.80%</td>
</tr>
<tr>
<td>Direct Writers</td>
<td>21.50%</td>
<td>21.90%</td>
<td>22.50%</td>
<td>22.50%</td>
<td>22.40%</td>
<td>22.20%</td>
</tr>
<tr>
<td><strong>Claims to Premium</strong></td>
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</tr>
<tr>
<td>Direct Line</td>
<td>65.50%</td>
<td>68.84%</td>
<td>71.85%</td>
<td>74.04%</td>
<td>66.77%</td>
<td>69.40%</td>
</tr>
<tr>
<td>Agency Writers</td>
<td>78.50%</td>
<td>78.80%</td>
<td>79.00%</td>
<td>85.00%</td>
<td>78.30%</td>
<td>79.90%</td>
</tr>
<tr>
<td>Direct Writers</td>
<td>86.30%</td>
<td>86.60%</td>
<td>83.70%</td>
<td>91.70%</td>
<td>80.90%</td>
<td>85.80%</td>
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</table>

The second element of Direct Line’s financial performance was its combination of pricing policies and retention rates. «Instant insurance» (i.e. insurance cover provided over the telephone and without agents) saved Direct Line’s customers up to 20 per cent on premiums was compared to those offered by agency or direct writers. But to translate «instant insurance» into superior financial performance, Direct Line required a very high retention rate. This was evident when in 1993 Direct Line achieved an 85.8 per cent year-to-year customer retention ratio. For that same year, the sector’s average retention rate was between 50 and 60 per cent.

On the other hand, Direct Line’s proceeds from investment income were seldom mentioned as a feature of the company’s successful financial performance. As can be observed in table 3, between 1989 and 1993 investment income represented an average


50 Compiled by the author from information in *Breaking the Mould* (16.7.1994).

51 *Marketing Week* (25.3.1994).
30.28 per cent of the annual profit after tax (and less than 20 per cent since 1993). The result was remarkable when compared with other insurers, which received all or more than all of their profits from investment income (more below).

Long-term business, and motor and travel insurance were the markets where traditional insures (i.e. composites) met head on with competition from bank-distributed insurance (i.e. bankassurance).\(^{53}\) The life and pensions or long-term business is the largest market for UK-based insurance companies and premium income from long-term business emerging from Britain represented some 80 per cent of total business.\(^ {54}\) Between 1992 and 1995, UK premium income from long-term business rose by 3.8 per cent whereas overseas life and pensions premium income rose by 23.1 per cent. At the same time, between 1992 and 1995 long-term insurance investments rose by 51.7 per cent and the income that the investment generated went up by 39.5 per cent.\(^ {55}\) Clearly, growth for UK-based insurance companies had been linked to developing more overseas long-term business premium income and continuing to invest in ordinary stocks and shares.

52 Compiled by the author from Direct Line Group, Annual Report and Accounts, Croydon (several years).
53 KeyNote, The UK Insurance Market (4th Ed),
54 Ibid., 54.
55 Ibid., 14.
Direct Line’s financial investment policy was quite different to the portfolio of life and general insurance companies. Direct Line’s management claimed that in motor insurance liabilities rise very quickly and, therefore, the ups and downs of the stock market could not provide for good risk management. Management believed that equity investment «doubled» the firm’s risk exposure. The combination of this rather «risk averse» attitude to the stock market and the healthy proceeds from portfolio investments mentioned above, suggests that managers found profitable portfolio investments other than government bonds and with less risk than the stock market. But as noted these investments contributed little to the «bottom line». Therefore, this was a customer-oriented company which was in a position to make money out of premium income as opposed to other insurance firms that required investment income to turn a profit.

Redefining Market Structure

Prior to 1985, insurance brokers displayed premium values of different insurers grouped in tables and according to the underlying asset (risk) to be insured (home, contents, motor etc.). Customers could then compare premiums at different companies and these premiums were known as the «standard rate». Direct Line’s telephone distribution changed the scheme through which customers discovered actual quotes when brokers approached insurance companies on their behalf. Direct Line’s quotes were made available over the telephone, instantly and on a standalone basis (i.e. without reference to competitors as insurance brokers did). In fact, this pricing approach ended the existence of the «standard rate» and insurance prices began to resemble a direct-insurer’s cost structure, portfolio risk and customer characteristics.

But Direct Line was not the first to by-pass brokers as a distribution channel. The first British firm to sell insurance directly to customers was established in 1961. Abbey Life aimed at combining Canadian sales techniques with more comprehensive and easier to understand life insurance policies. Regardless of the opportunity, during the following 34 years composites drifted to a kind of wholesaler role. RETAILING was surrendered to independent intermediaries (called insurance brokers). As a result, when banks and building societies entered insurance as brokers or direct issuers they found that composites lacked the advantage of controlled, pre-established distribution channels to sell insurance. The eventual success of Direct Line gave the composites a technology-based way to fight-back against other financial intermediaries, recovering some of their lost market share. However and as will be made evident below, technology also threatened the relationship between insurance firms and brokers which few established insurance firms were willing to change.

The earliest follower of Direct Line was established in 1988, in the form of a subsidiary of Royal Insurance called «The Insurance Service». Royal Insurance gave the new subsidiary a distinct name from the rest of the group in order to avoid upsetting brokers with whom it had a working relationship. However, Royal Insurance began selling

56 Peter Wood, founder of Direct Line Insurance, as interviewed in Channon/Cox, Direct Line Insurance (cf. n. 47).
58 Financial Times (7.8.1995).
59 BusinessAge (1.9.1993).
60 Lloyds List (26.4.1995).
personal cover directly over the telephone in 1994, using its own brand name (called «Royal Insurance Direct»), and simultaneously through The Insurance Service. The end result was that support of the parent’s advertising benefited Royal Insurance Direct while The Insurance Service scored badly in recognition tests.\textsuperscript{61}

Table 4 illustrates the growth of other insurance companies (and banks) using the same technology as Direct Line to sell directly to customers in retail finance markets. It then becomes clear that Direct Line’s innovative entry had modified core products and redefined the market’s structure.\textsuperscript{62} Further evidence of Direct Line’s influence on selling retail financial products emerged when, in the course of 1989 and 1990, 50 direct insurers were established in the UK. This was two years after Royal Insurance’s experience, and when Direct Line’s superior financial performance was evident. The proliferation of direct underwriting centres in Britain was such that in 1994 they captured approximately 31 per cent of the private motor insurance market, up from 17 per cent in 1992.\textsuperscript{63}

Many of Direct Line’s followers were telesales arms of traditional insurers and, alongside their telesales subsidiaries, many composites continued selling policies through brokers. Composites believed that the establishment of telesales outfits created conflicts with insurance brokers and with their brand image.\textsuperscript{64} Insurers’ lack of confidence reflected doubts about mastering the new «direct» channel and also, the poor management of brokers as a distribution channel.

In brief, one external element that allowed Direct Line to achieve competitive advantage had to do with the fact that composites’ response to Direct Line was not immediate. As stated by its founder: «To be honest I didn’t expect the industry to make it so easy for [Direct Line]. They ignored us for so long.»\textsuperscript{65} The five year lag in the response cost insurance companies dearly in terms of investments to develop adequate capabilities (specially related to computing capabilities and direct advertisement). However, the experience of The Insurance Service suggested that building these capabilities was a necessary but not sufficient condition to regain credibility and market share.

Direct Line’s strategy illustrates a case where an innovative entrant surmounted apparently high entry barriers by essentially changing the terms under which competition occurred. Direct Line’s technology could be (and was) adopted by a wide range of firms supplying retail finance both inside and outside Britain. Telephone call centres opened a distribution option and one that allowed even the smallest competitors to challenge retail finance markets by setting-up direct sales operations on a variable basis.

\textit{The Innovative Applications of Direct Line}

Alongside pricing policy and the response of competitors, another distinctive element that explained Direct Line’s success was its innovative IT applications and their support to improve customer service. The three most common features associated with these applications were:

63 \textit{Breaking the Mould} (16.8.1994).
64 \textit{Lloyds List} (26.4.1995).
65 Peter Wood in: \textit{BusinessAge} (1.4.1995).
Table 4: Selection of Direct Retail Finance Intermediaries, 1986 to 1996

<table>
<thead>
<tr>
<th>Name</th>
<th>Type</th>
<th>Owner</th>
<th>Country</th>
<th>Est.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Line Motor, mortgages, life</td>
<td>Royal Bank of Scotland</td>
<td>UK</td>
<td>1985</td>
<td></td>
</tr>
<tr>
<td>Celtic Autoquote Motor</td>
<td>Celtic Insurance</td>
<td>Ireland</td>
<td>1988</td>
<td></td>
</tr>
<tr>
<td>The Insurance Service Motor, home</td>
<td>Royal Insurance</td>
<td>UK</td>
<td>1988</td>
<td></td>
</tr>
<tr>
<td>GA Direct Motor, home, personal</td>
<td>General Accident</td>
<td>UK</td>
<td>1988</td>
<td></td>
</tr>
<tr>
<td>First Direct Bank</td>
<td>Midland Bank</td>
<td>UK</td>
<td>1989</td>
<td></td>
</tr>
<tr>
<td>Churchill Insurance Motor, home, credit cards</td>
<td>Winterthur (CH)</td>
<td>UK</td>
<td>1989</td>
<td></td>
</tr>
<tr>
<td>Eagle Star Direct Motor</td>
<td>Eagle Star</td>
<td>UK</td>
<td>1989</td>
<td></td>
</tr>
<tr>
<td>Royal Insurance Direct Life</td>
<td>Royal Insurance</td>
<td>UK</td>
<td>1992</td>
<td></td>
</tr>
<tr>
<td>Touchline Motor</td>
<td>General Minister</td>
<td>UK</td>
<td>1992</td>
<td></td>
</tr>
<tr>
<td>Admiral Insurance Motor</td>
<td>Brockbank Group</td>
<td>UK</td>
<td>1993</td>
<td></td>
</tr>
<tr>
<td>Alliance Auto Direct Motor</td>
<td>Alliance Insurance</td>
<td>UK</td>
<td>1993</td>
<td></td>
</tr>
<tr>
<td>Guardian Direct Personal</td>
<td>Guardian Royal Exchange</td>
<td>UK</td>
<td>1994</td>
<td></td>
</tr>
<tr>
<td>Banco 1 Bank</td>
<td>Unibanco</td>
<td>Brazil</td>
<td>1995</td>
<td></td>
</tr>
<tr>
<td>Línea Directa Motor</td>
<td>Bankinter/Direct Line</td>
<td>Spain</td>
<td>1995</td>
<td></td>
</tr>
<tr>
<td>Chase Direct Bank</td>
<td>Chase Manhattan Bank (NY)</td>
<td>USA</td>
<td>1995</td>
<td></td>
</tr>
<tr>
<td>Chem Direct Bank</td>
<td>Chemical Bank (NY)</td>
<td>USA</td>
<td>1995</td>
<td></td>
</tr>
<tr>
<td>Guardian Direct Motor</td>
<td>Guardian Direct (UK)</td>
<td>Ireland</td>
<td>1995</td>
<td></td>
</tr>
<tr>
<td>Virgin Direct Investment funds (Peps)</td>
<td>R Branson/ Norwich Union</td>
<td>UK</td>
<td>1995</td>
<td></td>
</tr>
<tr>
<td>Privilege Insurance High risk motor</td>
<td>P Wood/RBS</td>
<td>UK</td>
<td>1995</td>
<td></td>
</tr>
<tr>
<td>Banque Directe Bank</td>
<td>Banque Paribas</td>
<td>France</td>
<td>1995</td>
<td></td>
</tr>
<tr>
<td>Norwich Union Direct Motor, home</td>
<td>Norwich Union</td>
<td>UK</td>
<td>1996</td>
<td></td>
</tr>
</tbody>
</table>

Compiled by the author based on information from: Financial Times and The Sunday Business Post.
• Interactive systems. – Contracts indexed by customer name rather than by number.
• Fair quotes. – Relevant information to process claims and policies was retrieved from actual telephone conversations by queries made in a polite but precise manner.
• Enhanced customer convenience. – Retrieved information was directly transferred into actual policy formats (if quote accepted and paid through direct debit or credit card).

The client then foregoes the need to fill in forms or wrestle with paperwork.

These features suggest that interactive systems supported a separation of all pricing elements and conferred the possibility of examining the value chain from quote to settlement. Secondly, fair quotes produce more accurate information on the risk represented by type of customer profile since there is reduced risk of adverse selection. Thirdly, direct methods improve customer convenience and result in higher retention rates than other distribution methods.

The end result of direct operation was that Direct Line’s top management did not need to ask anybody for information because information could be retrieved from the system. Any query was possible as long as it was supported by the database which reflects the importance and time spent on its design by Direct Line’s original team.

At Direct Line all computer applications were integrated and the database stored information from all over the firm precisely when a transaction took place. As a consequence, Direct Line’s managers had a direct channel to craft strategy without any of the uncertainty about profit drivers and policy variables that generally applied. They could experience the effects of changes in IT or risk assessment queries on a real-time basis. Direct Line’s strategy made no need of middle management to process information about environmental conditions or strategy implementation and hence, was not subject to information delay or bias inherent in other situations. This de-layering of operations meant that approximately 80 per cent of the 3,000 strong workforce were involved in front-desk operations like telesales, teleclaims or claim evaluation.

The 1988 entry into home contents insurance illustrates how the anticipated advantage attributed to IT systems was explored to support a diversification move. Building societies had an advantage in terms of previous market knowledge. To add to this difficulty, Direct Line inherited a sub-scale book of business from The Royal Bank of Scotland which had major problems of adverse selection (security properties) and under-valuation. For a time, claim ratios and costs at Direct Line exceeded those of the main competitors in the home contents insurance market. Differences in claims ratios and costs evidently reflected under-priced high risk and under-priced business rather than the standard business attracted in motor insurance. However, even a non-optimal portfolio responded to the new process. Direct Line’s system supported a fast learning curve which allowed managers to fine tune the pricing policy and, eventually, they learned how to price home contents insurance more accurately than building societies. In the end, home contents insurance proved to be another success story for Direct Line.

67 Channon/Cox, Direct Line Insurance (cf. n.7047), 10.
68 Peter Wood, founder of Direct Line Insurance, as interviewed in: Channon/Cox, Direct Line Insurance (cf. n. 47).
Transferring Competencies to the Royal Bank of Scotland

The results of Direct Line’s financial success and innovative IT applications became a learning experience for The Royal Bank of Scotland. The phenomenon had its roots in the early 1980s. At the time, Peter Wood was a director at Alexander Howden (a UK insurance firm). There he conceived the idea for an outfit such as Direct Line. His employer was not interested and so he resigned.

Peter Wood «[...] approached a number of other institutions before he made his way to [...]» The Royal Bank of Scotland.69 The people at The Royal «[...] weren’t too worried about losing £20 million, more about losing reputation. But in the end, they just wanted to try something new so they backed me [...]» The bank kept a very close watch on its new investment for a good five years, before a new chief executive, George Matthewson, took over. He quickly realised the potential of Direct Line, and was happy to let [me] run the show. Now he asks me for advice on how to make money. I have to say: ‘Sorry I’d love to, but I’m too busy’.70

One lesson from Direct Line to managers at the bank was not depending solely on Management Information Systems to discover new growth opportunities. Rather, managers must rely on having good IT and being able to apply information systems to pursue new growth opportunities.71 Direct Line managers considered that the source of their competitive advantage could not be reduced to IT providing cost-effective solutions. Rather they believed that Direct Line’s competitive edge emerged from successful execution of a product market and a customer group diversification move within retail finance markets.

Discussion

This research illustrates how a subsidiary of the Royal Bank of Scotland called Direct Line Insurance captured an opportunity presented by technological change. The strategy seemed to offer the added benefit of greater cost efficiency. For managers of the Royal Bank of Scotland, IT appeared to lower entry and exit barriers and promised high sustainability of competitive advantage. The strategic intent in the case of the Royal Bank of Scotland suggested competitive considerations were at a premium because unsolicited takeover bids in the early 80s put pressure on managers to create growth opportunities. Managers at Royal Bank of Scotland were not only challenged to create several new growth opportunities but also, to take advantage of regulatory change in western Europe (i.e. the Single Market in Financial Services programme). But in spite of European and British regulatory changes during the 80s and early 90s, the main success of The Royal Bank of Scotland in retail financial services, and a factor which changed the whole strategy of the bank, came not from geographical and product diversification strategies within retail banking but from product-based diversification in the retailing of insurance through a telephone-based operation. This success demon-

69 The Guardian (25.11.1994).
70 Peter Wood in: BusinessAge (1.4.1995).
strated new possibilities in the provision of retail financial services and showed a new use of IT applications to implement banks’ corporate strategy.

The Royal Bank of Scotland was primarily a low risk follower, aiming to deflect further unsolicited takeover bids. To managers of RBS, the fact that Direct Line redefined the rules of competitive engagement would be beneficial since it did not create a threat to any of The Royal’s potential predators.

The subsidiary started as one of the alternative entries into bankassurance explored by managers of RBS. Direct Line was established not as a product of The Royal’s internal ingenuity since they were approached only after the founder failed to find financing opportunities amongst established insurers. Initially a tactical innovation designed to supply a limited set of retail financial services, Direct Line evolved to create a new distribution channel that posed a major threat to the strategies and market position of insurance companies and their agents. This was a case where an innovative entrant surmounted apparently high entry barriers by essentially changing the terms under which competition occurred. Direct Line’s characteristic technology and marketing provided The Royal Bank of Scotland with a swift and profitable penetration of the UK insurance business. Furthermore, this technology was successfully replicated (with the same results) in countries such as Spain and Germany.

For established insurance firms, Direct Line’s financial results raised the issue of whether core capabilities in retail insurance encompassed underwriting or underwriting and investment management. Increasing profitability from Direct Line’s premium income suggested that diversification moves of other insurance companies into investment management (and their reliance on investment income for profits) had made the core business unprofitable. Insurance companies increased the profitability of a previously unprofitable core business as insurance companies adopted telephone technology. The technology gave insurance companies a way to fight back against the entry of banks and building societies to retail insurance markets and the possibility to profit from premium writing (rather than investment income). However, it took the visionary strategy of Direct Line’s founder rather than the previously unprofitable tactical entry of The Royal Bank into bankassurance for established insurers to capture new growth opportunities associated with telephone sales (such as improved market segmentation possibilities through a new distribution channel).

The unanswered issue is why Direct Line did not internationalise more quickly. In terms of growth opportunities there seem to be few limitations either from managerial diseconomies or with computer capacity. Yet Direct Line used a strategic alliance to penetrate the Spanish market. The alliance would suggest the possibility that regulatory approval and compliance were perceived as barriers to entry in spite of the EU Single Market reform programme. As a result, future research on the adoption of technological change in financial markets (and, in particular, IT applications in retail banking) should further explore how regulatory approval and compliance are barriers to enter bank markets, and also how environmental change modified the adoption of alternative, equally effective, cost reducing, IT-based applications by bank managers.

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