302.

Business Strategies for Retail Banking
Introduction

In 2009 the share price of Citibank fell below the psychological dollar level and the financial services industry saw its profits spiral downwards; two years later, an article in the *Harvard Business Review* trumpeted the fantastic financial performance of Standard Chartered bank at that time. To quote the then-CEO, Peter Sands: “we had a very clear strategy, and we stuck to it. Everybody understood it and we were very, very focused.” Recent events reveal that the bank (called a ‘rogue institution’ by the New York State Department of Financial Services) was accused of scheming with the Iranian government to launder more than $250 billion over a decade – clearly covering the period in 2009 when it was lauded for being client-focused by the *Harvard Business Review* article. Presumably, in the context of the article, the leaders of Standard Chartered bank reflect ‘high ambition’ which means “that they forge a more powerful strategic vision by drawing on an expansive view of their companies’ heritage and cultural, organisational and social assets”.

Business strategy is simply a game plan for success. Of course, business strategies result in financial projections that guide business unit strategic goals. But a laser-like focus on financial projections without a conscious effort to create key performance indicators (KPIs) that encourage principled and professional employee behaviour and a commitment to reduce reputation risk would likely end in abject failure.

Sometimes bank executives fail to recognise that business strategies must result in properly aligned risk and financial management discipline. Indeed, this is where the potential for financial trouble lurks. For example, smitten by an ambitious balance sheet expansion, Northern Rock pursued a financial strategy of over-reliance on wholesale funding. The 2011 Barclays annual report states that part of the execution of its strategy is a set of four priorities that include ‘citizenship’. Specifically, it is stated that “our strategy and our execution priorities allow us to continue to serve the wide ranging needs of our customers in a safe and stable manner that is aligned with our responsibilities as corporate citizens…” The recent Libor fixing scandal makes a mockery of this priority.

The remainder of this module is organised as follows: Chapter 1 defines a business strategy and then shows that the development of business strategies is an ‘inside-out’ process. Chapter 2 shows how the PEST model and the Ansoff Matrix are utilised in creating a business strategy for

retail banks. Chapter 3 considers steps in the execution of business strategy in retail banking. The module concludes with a summary and multiple choice questions.
Arguably business strategy is necessary for a bank to sustain competitive advantage and win in the long run. It is noteworthy that Y. Y. Chin, former executive vice president of OCBC Bank, Singapore described a winning bank strategy as follows: “The bank that best addresses and anticipates customers’ needs, delivers consistently higher quality service and connects to the customer via their channel of choice, wins.”

In this module, it is asserted that an effective retail bank business strategy is a combination of forward market positioning and risk mitigation followed by a HRM response to close any core competency gap that may result.

Specifically, this approach comprises two important stages:

a. Determine the bank’s market opportunity within constraints created by available capital, risk tolerance, the Basel Committee on Bank Supervision (BCBS) and national and international legal constraints as well as global competitive forces – i.e., forward market positioning;

b. Determine the level of core competencies required for the bank to profit from the identified market opportunity and compare with existing set of core competencies. This results in a potential core competency gap that is addressed by the bank’s human resource team – i.e., talent management.

In short, this approach is based on the equation:

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\text{Bank’s business strategy} = \text{Strategic (forward) market positioning} + \text{Talent management to close a potential core competency gap.}
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* Reported in Retail Banking Strategies of the Future by Soundara Kumar, GM Personal Banking, State Bank of India
† A core competency is typically defined as a business activity that distinguishes one company from another, creating a competitive advantage for the company. In the context of the resource-based view of a bank, we define a core competence as a skill (i.e., combination of expertise and experience) that is difficult to imitate or duplicate. It is a concept that was originally introduced by Prahalad and Hamel in their book Competing for the Future, Harvard Business Press, 1990.
An expert in retail banking may find this equation quite appealing. Indeed, strategic market positioning is based first on identifying customer needs. Indeed, Porter* refers to this as 'needs-based positioning' and includes the case where needs vary inter-temporally – the so-called life cycle model. This is the basis for business strategy in retail banking and reflects the main point raised above by Y. Y. Chin. But market positioning alone is not sufficient to create long-term sustainable financial performance. The critical link is having proper risk mitigation and the right people in the right positions. The human resource response – to fill any potential core competency gap – is crucial for success. The importance of this part of the business strategy is sometimes missed, leading to the bank earning suboptimal bottom line results.

It is noteworthy that the People Management (Retail Banking II) module emphasises this response. There it is noted that, based on the resource-based view of a retail bank, core skills and experience create a key source of competitive advantage for a retail bank. All retail banks have similar products and channels. Competitive advantage is derived from people skills, the corporate culture and brand positioning that are not easy to duplicate or imitate by competitors.

In summary, long-term sustainable financial performance in retail banks depends critically on closing a potential skills gap that results from strategic market positioning. Observe that this approach has reversed the order of the traditional SWOT (strengths, weaknesses, opportunities and threats) model. A market-focused company should first have an external review and then an internal analysis. It is not proposed that SWOT should be discarded, only that it should be done in the right order. A large core competency gap is a sign of danger for the company. It may suggest that the retail bank has veered away from its core business.

**The Lesson**

Stay close to strengths and mitigate weaknesses. This is a guiding philosophy underlying business strategies in retail banking. By analogy, a cricket team should not consider playing baseball even if they may look similar in some respects. Stay close to what the bank does best and seek profitable growth by leveraging the bank's core competencies. Do not venture into unrelated businesses even if they look similar and may even generate high margins. Know when you have strayed from risk into uncertainty.

**Open Question #1**

Do you agree that there is a danger for the conduct of bank strategy if there is a large skills gap?

**Definition of Business Strategy**

The term ‘strategy’ is derived from the Greek word ‘strategos’ and was first applied in the conduct of warfare. It literally means ‘the art of the general.’ Michael Porter† defined a business strategy as “the creation of a valuable and unique position … the essence of strategic positioning is to choose activities that are different from rivals.” For retail banking, we propose to modify this definition. In the preface, we emphasised a key principle: a retail bank will outperform its competitors only by creating a competitive advantage and preserving it. Since retail banking is a people business, a bank’s competitive advantage is created by its unique core competencies. Put simply, it is all about the core skills and experiences that employees bring to the bank. Obviously, retail banks serve the same set of customers (individuals and SMEs) and have basically the same products and the same channels of distribution. Of course, there are niche markets where some banks (e.g, direct banking) have chosen to do business. Some banks (e.g, in emerging markets such as Nigeria) operate mainly in yield spread markets. But the key differentiating factor in all retail banking is the available stock of core competencies and experiences of its employees. Hence the ‘unique and valuation position’ espoused in the definition by Porter depends crucially on the human capital available to the bank. So here is a definition of strategy for a retail bank:

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†† Ibid.
Strategy in retail banking is the creation of a valuable and unique position and the preservation of that position by the bank’s employees.*

There are several implications of this definition of business strategy in retail banking.

First, a retail bank should carve out a market position that is supported by its unique strengths. In more detail, the business strategy sets out objectives and execution plans for its market segments over a specified time – for example, three to five years. Hence, the retail bank could develop a strategy for growth in its affluent market segment while consolidating its mass market.

Second, business strategy in each market segment will determine the bank’s degree of risk. Clearly, there is a high degree of dependency between the bank’s business strategy and its risk strategy. Indeed, the bank’s risk strategy is derived from its business strategy and the former should set out all sources of risks that the bank’s strategic objectives will potentially create. Importantly, the risk strategy will set out actions to control and/or mitigate these risks.

Third, as was stated above, to preserve its unique position, the stock of human capital (the bank’s unique strength) must be continually upgraded; the key to preserving a bank’s unique position in the market is its stock of human capital, which must not be allowed to be impaired over time. Just as tangible assets depreciate over time, human capital may be impaired over time as employees fail to keep up with best practices in the functional disciplines of retail banking.

Open Question #2
Do you agree that the head of the bank’s HR should be involved in the development of the bank’s business strategy?

Fourth, business strategy in retail banking is rendered relatively more complicated by the stringent constraints imposed by Basel III. Basel III limits risk-taking, requires more capital to absorb risks and minimum liquidity standards. The implication is that decision makers will have to take into account that retail banking is becoming closer, as a business model, to a utility. This puts business strategy in a different context from investment banking, which is more of a deal-oriented business.

Fifth, operational excellence, risk and capital management are servants of business strategy in retail banking. They are derived sub-strategies to improve the likelihood that the bank’s strategic objectives are achieved. Indeed each presents a source of competitive advantage for the bank – that is, a source of value for the customer that exceeds the cost of creating it. Four typical sources of value creation in a retail bank are as follows:

Operational Leadership
Banks that choose to focus on this source of value creation will likely choose to implement the recommendations of the Retail Banking III module titled ‘Operational Excellence in Retail Banking’. These include multi-channel management; provision of delivery and service guarantees and service-oriented back office design.

Product Leadership
The Retail Banking III module titled Achieving Profitable Growth demonstrates the value creation potential of a policy that emphasises portfolio product management. In particular, there is a recommendation to streamline a bank’s product portfolio by phasing out products with low revenue potential. The retail bank should consider strategic alternatives that include: new products for existing markets (product development) and existing products for new markets (market development).

* Mintzberg (1994) in his *Rise and Fall of Strategic Planning* defines (similar to the traditional 4Ps model of marketing strategy) a 5Ps model: plan, ploy, pattern, position and perspective.
Customer Intimacy

Arguably, the Treacy and Wiersema* model is closest to the enlightened customer-experience approach that has become popular in today's banking climate. This model is highly focused on understanding customer needs and developing customised solutions, in contrast with a mass-market 'product' model. The implications of this model are discussed in the module titled 'Customer Care.'

Distribution Leadership

Banks that focus on this source of value creation will likely implement the recommendations of the Retail Banking III module 'Operational Excellence in Retail Banking.' Note that distribution leadership is seen as an important component of operational leadership. This is because channels are links between the bank and its customers and hence the centre of banking operations. As demonstrated in the module titled 'Achieving Profitable Growth,' channels that create substantial market reach and reduce risks associated with reputation, cannibalisation and client ownership are likely to create value for the bank.

Attention is placed on relationships and results – specifically, relationships will produce results. This means drilling down into the needs of prospects and customers and understanding how to meet and eventually exceed their expectations, producing deeper relationships and renewable success along the way.

Retail banks have the foundation of customer information that is essential to building an excellent customer-intimacy structure.

The struggle for most banks is to properly maintain a bilateral flow of information between the bank and its customers – to ensure ongoing attention to changing customer needs and demands. There is no doubt that the customer-intimacy model is the most difficult of these value-creating approaches to emulate consistently and successfully.

Sixth, while the approach to business strategy development is typically top-down, there should be a simultaneous consideration from the bottom up. The reason for this important point is that in the top-down approach, where market size, expected volumes and margins are determined, financial projections are created. These projections impose a constraint on the bank's resources, which begs the question – based on the current resources (financial and otherwise), can the bank channels deliver the financial projections? In simple words – are the financial projections realistic based on current bank resources? This is a key consideration that is created when both the top-down and bottom-up approaches converge and a certain sense of pragmatism emerges.

We summarise a key point in relation to the resource-based view of business strategy in retail banking, that is: innovation in retail banking is not solely derived from scanning the market for business opportunities but also importantly from the core skill development within the bank. A retail bank cannot leverage a market opportunity without having the required set of core competencies.

Chapter 2: Creating a Business Strategy for Retail Banks

Who is responsible for the development of the bank’s strategy? There is evidence that senior management creates business strategy while the board reviews and approves it. (McKinsey Quarterly, July 2011). This role of the board is supported by the BCBS’ Principles for Enhancing Corporate Governance (October 2010), which states that “the board should approve and monitor the overall business strategy of the bank”.

As stated above, a retail bank’s strategy is a combination of a forward market positioning followed by a HRM resolution of a potential core competence gap. The SWOT approach (in reverse order)* is used to create a business strategy for retail banking. In addition, decision makers must take into consideration the Basel III constraints on risk-taking via a leverage limit, liquidity standards as well as capital requirements. In addition, various national legal and statutory obligations also provide constraints to the formulation of a bank’s business strategy. Consequently, the bank’s market space is constrained. In retail banking, governance and ethical standards also imposed an important constraint on the bank’s business strategy. This constraint is typically not explicitly stated in the academic and professional literature as an important hurdle. However, in the resource-based view of the firm, governance and ethical culture are components of a bank’s organisational capital, a component of intellectual capital. Hence governance and ethics must be viewed as an important constraint on where the bank positions itself to do business with customers.

Open Question #3

Do you agree that a bank’s business strategy is constrained by Basel III capital, liquidity and leverage constraints?

Business Strategy and the Bank’s Risk Appetite Statement

The link between business strategy and risk management is through the bank’s risk appetite statement (RAS), a fuller discussion of which is presented in the Risk and Capital Management

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* The TOWS is a reverse sequence of the SWOT model. They are identical except that, in the TOWS approach, the decision maker goes from the external to the internal. The TOWS model was introduced by Heinz Weihrich in 1982 in a paper in Long Range Planning
module of this course book. A key part of the RAS is the determination of the level of risk the bank is willing and able to take with input from the board and senior management. At the level of the bank, risk appetite is determined by constraints placed on, for example, capital adequacy and earnings volatility. But these metrics must be embedded at the lower operational levels of the bank where risk limits are placed. With an RAS fully embedded in the bank, there is a *de facto* constraint on business strategy. As pointed out in ‘Risk Appetite: Linkage with Strategic Planning’ by Shang and Chen and published by the Society of Actuaries (2012), “With a clearly defined risk appetite, constraints are known when making strategic decisions.” In summary, a clearly articulated RAS that is fully embedded in the bank provides boundaries that contain the bank’s strategy.

We now begin the process of developing business strategies in retail banking with a consideration of the so-called PEST model.

**The PEST Model**

The first step in the creation of strategy is a detailed study of macroeconomic environment that the bank will likely face over the medium term. This is not a market analysis, which typically involves, in part, a study of the competitive forces that the bank is expected to face. Rather, it is a study of the large macroeconomic forces that will affect the activities of the bank. The PEST model deals with the Political, Economic, Socio-Cultural and Technological environment that is likely to emerge in the medium term.

The issues to be considered by the bank’s decision makers are:

- Expected changes in monetary and fiscal policy. Note that monetary policy has a direct bearing on the shape of the domestic yield curve that determines the bank’s net interest margin.

- Expected regulatory and legal changes that affect profitability and capital requirements, both of which will determine the expected RAROC through the amount of economic capital required to absorb risk.

- Expected technological changes that affect the life cycle of the bank’s products and the choices for bank channels. Recall in the product portfolio model, it is demonstrated that technology can hasten the decline of some bank products.

Socio-demographic changes affect the matching of the product life cycle with the family life cycle and hence determine the conduct of market segmentation.

**The SWOT Model in Reverse (TOWS)**

SWOT is an acronym for Strengths, Weaknesses, Opportunities and Threats. The basic intuition of the SWOT approach is based on the assertion that effective business strategies are based on a good fit between the bank’s internal resources (Strengths and Weaknesses) and external possibilities (Opportunities and Threats). The ‘reverse SWOT’ or TOWS approach is a view of first considering the external possibilities and then match with internal resources. It is an ‘outside-in’ approach. Specifically, this latter approach is a consideration of the external market opportunities and competitive threats.

This is the objective of strategic market research – assessment of the profitability potential of a new market segment that could be addressed by existing or new products or the development of new products that would address the needs of customers in an existing market segment.

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* There is another version of this model - PESTEL that adds two more factors - Environment and Legal. These factors are included in the discussion of PEST. For example, legal is part of compliance while environment, which includes corporate social responsibility, may be addressed under Socio-Cultural issues. This is a choice and senior management may address these two factors separately if so desired.

† The ‘existing market’ may be called the ‘home market’
The choices that the retail bank faces is highlighted in a typical Ansoff matrix.*

302.1: The Ansoff matrix

The four choices for a business strategy are now clear and the selected choice or choices will also determine the bank’s growth† strategy. We examine each choice in turn.

**Market Penetration**

A common strategy in retail banking is to increase market share whereby existing products in the bank’s portfolio are offered to prospects and existing customers with the aim of cross-selling or increasing ‘customer share’. Existing markets are also called home markets. It is a relatively low-risk strategy since the demographic and psychographic characteristics of existing customers are well-known to bank decision makers.

**Product Development**

This strategy aims to provide new products to existing market segments. It is appropriate where customers remain with the bank for a lifetime, with different needs arising at different stages of the life cycle. It is regarded as low-to-medium risk since the focus is on existing markets. The bank may also create new features in its existing products to ward off competition or to better meet customer needs.

**Market Development**

This is a relatively riskier strategy than product development. Introducing existing products to new market segments is riskier than creating new products for existing market segments. It is a controlled growth strategy, that builds on market share.

**Diversification**

This strategy is the riskiest – new products for new markets. It is consistent with a bank that has a high tolerance for risk since the bank has no experience in the market segment and is uncertain whether the product features will actually meet customer needs. It is decidedly riskier than a market development strategy, which we see as more feasible than the risky strategy of new products in new (i.e., non-home) markets.

* The Ansoff matrix was developed by Igor Ansoff and was first published in his article “Strategies for Diversification” in the *Harvard Business Review* in 1957
† The next module will deal with strategies to achieve profitable growth
The Time Horizon Model

It is clear that a retail bank can position itself in more than one of the quadrants in the Ansoff matrix or even in all of them. Indeed, if we recast the Ansoff matrix into a time-horizon model, a clearer view is obtained.

![Time Horizon Model Diagram]

302.2: Time-horizon model

Note that this model shows that greenfields take a longer time to show profit since the bank focuses on creating a viable market share on which to build a business. Product and market development are two strategies that are intended to grow the business at higher margins. The current business is likely low margin and the bank makes an effort to increase sales by cross-selling or even deep-selling.

To illustrate this, we report on the current business strategy of Ecobank, a pan-African bank.

“As a group, our strategy is to build scale through organic growth and acquisitions, and grow our businesses in existing markets and expand into new markets.”

It is noteworthy that this strategy can be placed quite appropriately in an Ansoff matrix. The strategy to grow organically and by acquisitions poses different sources of risk and will be considered later in this module.

Another example of a business strategy that is more general when compared to that of Ecobank is the statement provided by Abu Dhabi Commercial Bank (ADCB): the 2010-2012 strategy is based around five key themes:

- Defend, maintain and grow ADCB’s business in the UAE.
- Create balance sheet stability through liability growth.
- Develop a culture of service and operational excellence.
- Manage ADCB’s risk to global best practice standards.
- Retain, attract and award the best talent in the UAE.

If we place this strategy statement in our model, we see that the first statement fits the Ansoff matrix very well but without the specifics presented in the strategy statement for Ecobank. The other statements are asset liability management, customer-centricity, risk management and human capital management respectively.

The next step in the implementation of the SWOT model is internally focused. Each of the three
main strategies identified in the time horizon model requires a particular set of core competencies to implement the selected business strategies. For example, to implement a strategy of cross-selling, relationship management is a required core competency. Similarly, the risky strategy of entering greenfields demands that bank staff assess and monitor the unique risks they face. These are new market segments for the bank, and there is no prior experience with the new products. In addition, since building market share to a critical level is a priority, the bank can build up substantial sunk costs – that is, costs which are normally not recoverable. Bank officials would have to worry about the implications of the ‘sunk cost bias’. This bias states that when sunk costs reach a high level, managers are likely to act in peculiar ways and seek to justify even a known unprofitable greenfield. There is an old statement in economics about sunk cost bias - high sunk costs are a barrier to exit. Apart from this behavioural bias, greenfields are inherently risky and require more economic capital to absorb the equivalent risk-weighted assets.

The growth opportunities embodied in both the product and market development strategies also require bank staff to have core skills and experience in dealing with new markets or new products that are sources of high margins for the bank. The main point is that each location in the Ansoff matrix derives different levels of risk and requires different types of core competencies to mitigate these risks.

It is now the obligation of the bank's HRM department to determine the skills required to meet the human capital demands of the selected business strategy. This set of required competencies is then compared to the existing skills in the bank. This may create a core competency gap. This gap is most likely increasing as we move along the time horizon model - least for market penetration and greatest for greenfields.

If the core competency gap is large, the bank may not be able to deliver on its strategic objectives: it is a sign that the bank has strayed from its core business. An extensive hiring programme to reduce the core competence gap is not feasible, nor is it recommended. Instead, decision makers should reconsider the bank's strategy and stay closer to its core business.

While some training may be required, it is important for HRM to ensure that the right person is matched with the right job. This is called ‘talent management’ – the HR obligation to match talent with function for best results.

This completes the process for developing business strategies for a retail bank. We restate the basic steps:

- As the first part of the SWOT model (applied in reverse), create an Ansoff matrix of the four main business strategies for the bank. Get a better understanding of the Ansoff matrix by creating a time horizon model from the basic business (utility) to growth opportunities to greenfields. This is forward market positioning.

- The second part of the SWOT model requires an estimate of a potential core competency gap. This gap is most likely increasing as we move along the time horizon model – least for market penetration and greatest for greenfields. We do not recommend getting to far right on this core competency requirement continuum.

- A large core competence gap is a red flag. The business strategy is likely wandering away from the bank's core business. Return to your core business.
While some training may be required, it is absolutely important for HRM to ensure that the right person is matched with the right job. This is called ‘talent management’ – the important HR obligation to match talent with function for best results. This completes the process for developing business strategies for a retail bank. We restate the basic steps:

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The Special Case of Diversification in the Ansoff Matrix

A diversification strategy involves entering new markets with new products. In this case, the method of entering new markets (regionally or internationally) is crucial for building market share and eventually achieve profitability. A common way of entering new markets is through mergers and acquisitions.

Theoretical Rationale for Mergers and Acquisitions

“The economics of bank consolidation is based on the theory of incentives for M&A. Economic theory of incentives for M&A relies on two main points of view: the wealth maximisation of
shareholders and managerial self-interest (O’Keefe 1996). The wealth maximisation theory treats M&A decisions as any other investment decisions of both acquiring and target banks driven by potential synergies that may arise from their merger. For example, synergy is said to occur when the merged entity performs better than both of the banks individually or the long-term market value of the merged entity becomes greater than the simple sum of the individual banks. Sources of such synergies include portfolio risk diversification, economies of scale and scope, expansion into new geographical markets, technology, market power, and so on.”

“The empirical literature analysing the effects of mergers and acquisitions on bank performance follows two major approaches. The first major approach follows the event study type methodology, often based on changes in stock prices around the period of the announcement of the merger (Cybo-Ottone and Murgia, 2000; Houston et al., 2001; Scholtens and de Wit, 2004; Cornett et al., 2006; Campa and Hernando, 2006; Campa and Hernando, 2008; Altunbas and Marques, 2008; Petmezas, 2008). These studies typically try to ascertain whether the announcement of a bank merger creates shareholder value, normally in the form of cumulated abnormal stock market returns for the shareholders of the target, the bidder, or the combined entity. The second strand of literature analyses the impact of mergers and acquisitions on bank efficiency. These studies typically examine the productive efficiency indicators, such as cost, profit, and/or technical efficiency (Kohers et al., 2000; Hahn, 2007; Koetter, 2008; Alsharkas et al., 2008). The empirical evidence from the US and Europe generally suggests that the acquiring banks are relatively more cost efficient and profitable than the target banks (Berger and Humphrey, 1992; Pilloff and Santomero, 1997; Peristiani, 1997; Focarelli et al., 2002).†

The main point is that when a retail bank develops a strategy to enter new markets, regionally or internationally, the factor that has an over-riding influence on the decision is cultural distance. This variable refers to the ethical culture of the retail bank when compared to that prevailing in the intended new market. There is exhaustive literature showing that cultural distance is an important determinant of eventual success in entering foreign markets. The caveat for the banking executive is that cross-border mergers are fraught with significant risks and potential for unintended consequences.

The focus of new market entry should be within the home country and geographical region before stepping into the international scene. It is also always a good reminder that moving far away from the traditional home base can be overly risky and expected returns may be slow to materialise. An article in The Wall Street Journal states that, “the likelihood is that HSBC will follow the exit from markets such as Japan, Georgia and Thailand with an exit from the Philippines, Pakistan, Sri Lanka, New Zealand and others, said Mediobanca Securities in a note. While the market will applaud this latest development, there is a growing sense of impatience about converting these initiatives into stronger returns.” (13 March 2012)

What is the lesson here?

When entering new markets as part of a bank’s business strategy, do not wander off into markets that are likely to create cultural dissonance. For retail banking this is the key variable to consider. It will also require unique core competencies to reduce the cultural noise. While it is easier to deal with different regulatory regimes and degree of market openness, understanding customer needs in the presence of cultural dissonance presents a steep hurdle. So stay close to home markets and venture out of regional markets before wandering off to foreign lands. Retail banking is a local business.

The development of business strategies (for selected market segments) is followed by an implementation plan. The anticipated value creation from the selected business strategies is completely dependent on the execution plan. This is how the bank’s competitive advantage is transferred into long-term profitability.

† “Do mergers and acquisitions lead to a higher technical and scale efficiency? A counter evidence from Malaysia” by F Sufian and M Shah Habilullah, African Journal of Business Management Vol. 3 (8), pp. 340-349, August, 2009
Chapter 3:
Executing Strategy Effectively

Executing Strategy Effectively

The final step in the ‘quest’ for sustainable competitive advantage is the execution of strategy. Remember that strategy formulation and execution are interdependent. Execution is the link between strategy and performance.

*Get your best people to execute - that is where ALL the benefits of strategy lie. Execution is a process – the payoff is down the line.*

Below is an example of a banking strategy with an execution plan obtained for Barclays Bank and summarised on its website (under ‘investor relations’).

### Executing our strategy

Our integrated universal banking model has enabled us to focus on our execution priorities: capital, returns, income growth and citizenship.

- **Capital** – our Core Tier 1 ratio stood at 11 percent at the end of September 2011, and we will continue to create internally any additional capital that we will be required to hold to meet regulatory change over the coming years.

- **Returns** – our commitment is to deliver a 13 percent return on equity by 2013, and our adjusted return on equity improved to 8.1 percent at the end of September 2011 (from 6.5 percent at the end of September 2010).

- **Income growth** – we have already taken decisive action in order to improve performance. These results demonstrate that our efforts are starting to pay off, but we acknowledge that more hard work is required.

- **Citizenship** – we remain committed to lending in the UK and are on track to exceeding our Merlin goals.
Income growth – we have already taken decisive action in order to improve performance. These results demonstrate that our efforts are starting to pay off, but we acknowledge that more hard work is required.

Our strategy

The integrated universal banking model is the best one for all our stakeholders. It is the model that has enabled us to:

- Build a bank that is personified and balanced by geography and business lines, by customers and by funding sources;
- Offer the best solutions for our customers and clients;
- Operate profitably throughout the crisis, offering security for customers as well as stability to the financial system as a whole.

From an organisational perspective, according to Gary Neilson, Karla Martin and Elizabeth Powers, the top five key traits for effective strategy execution are:

1. Everyone has a good idea of the decisions and actions for which he or she is responsible;
2. Important information about the competitive environment gets to headquarters quickly;
3. Once made, decisions are rarely second-guessed;
4. Information flows freely across organisational boundaries; and
5. Field and line employees usually have the information they need to understand the bottom-line impact of their day-to-day-decisions. In essence, execution effectiveness is about information, decision rights, motivators and structure.

In addition to the organisational traits, there are some other keys to successful execution. We will discuss four additional areas that specifically relate to a customer-focused retail banking business.

These are:

1. Understanding the uniqueness of retail banking in development of appropriate business plans;
2. Customer-centricity at the core of execution;
3. Using the appropriate KPIs to measure and drive the right results; and
4. Culture, and more specifically training.

It is important to note that while execution is critical to success, if you do not get the business strategy right, execution – even if effective – will produce the wrong results. Furthermore, execution must not be seen as a step that follows business strategy development. Rather, both in top-down and bottom-up (i.e., where execution is assessed) cases, it must be conducted as a coherent whole and as simultaneously as possible.

Industry uniqueness

As pointed out several times so far, retail banking is indeed a unique business. Many, if not most, of the world’s largest banks have committed tremendous resources to their retail banking activities. The truth is that most of those banks don’t really understand or appreciate the potential of their
retail banking businesses. It might help if retail banking was more of a static business, but it is difficult to comprehend what amounts to a moving target.

Therefore, strategic planning and execution for a retail banking business is extremely challenging. Retail banking customers’ needs are continuously evolving, and retail banking planners cannot depend on any models more than six to 12 months old. That’s demanding, to be sure; not many old-line commercial or retail banks can deal with that type of uncertainty. Therefore, adjusting organisational insights on an ongoing basis requires a nimble, responsive business plan as well as flexible management. Also, such things as regulatory and dislocation pressures and an increasing transparency ‘push’, e.g., the Retail Distribution Review in the UK, are adding to complexity. The consistent volatility of markets is a key indicator of the new state of derived volatility in financial services.

**Business plans and customer-centricity**

As stated above, effective execution of strategy requires a clear link between the planning and budgeting process. However, because the customer is always in the middle of the ideal retail banking business plan, these plans are fairly market-agnostic as they are developed (much more so than in other industries). That might seem to be a bit heretical; after all, doesn’t any business plan require market sensitivity? The answer to that question is yes. However, the level of sensitivity to specific market conditions is much less because the needs of retail banking customers are basically the same across the world. That being said, there are differences between established and emerging banking markets and the level of market sensitivity does vary across different retail banking segments: e.g., sensitivity is less in private banking than in mass-market banking.

It was noted earlier that models that serve as the bases of retail banking planning shouldn’t be any older than six to 12 months. Conversely, the outputs of that planning should not be for a time horizon of longer than five years (although we recommend three to five years) – it is almost impossible to forecast any further than that in today’s changing business environment. Also, we have observed that the quickly evolving needs of the retail banking customer demand continual attention by their financial-services providers. Even the bold organisations that decide to extend their planning to the outer reaches of the recommended time horizon must recognise that an annual review is warranted.

Whatever business plans are developed to address those customer needs, easily understood and clearly defined objectives must be an integral part of them, as should the methods of achieving those objectives. Also, the metrics applied against those objectives must be clearly defined, understood, measurable and achievable; and success against those metrics should translate into success for the entire retail banking enterprise (‘linkage’). Also, this process should actively involve the frontline of the retail bank – those staff members who populate that essential line of interaction must become the de facto voice of the customer during the setting of budgets and targets.

All retail banking business plans should begin and end with the customer – and, as we just said, to do this effectively requires involvement of key individuals from various frontline roles, such as face-to-face (branches), online, mobile or call centres. Knowing the needs and demands of retail banking customers, i.e., the value drivers, is a key element of the process, and senior retail bankers must be able to identify customer trends to effectively, and profitably, respond to those needs and demands. Retail banking management’s confidence in the translation of that customer voice should be actively tested during this process to maximise the return on interaction. The interesting point is that even though most retail banks have not fully adopted a value proposition based on customer intimacy, they are continuing to make significant investments in the customer experience. What return on investment will be achieved here?

If customer intimacy is the value proposition and developing customer solutions is the strategy, so customers must be at the heart of executing initiatives. Retail-customer trends are important, but banks must modulate their business plans. As stated earlier, flexibility is essential, but responses must not be knee-jerk, and measuring customer responses to any initiative is a must.
Key Performance Indicators (KPIs)

The guiding principle in designing KPIs is that they are intended to increase the likelihood of success in achieving the strategic objectives that emanate from the bank’s business strategy. This is the execution of performance management – a module in Retail Banking II of the RBA programme. There it is demonstrated that, in designing appropriate KPIs, we must be wary of some common traps.

When tracking the KPIs that underpin the performance-management system, organisations must avoid a number of bad practices.

**The Measurement Trap**

When collecting data, be cognisant of any change in the method of collecting and recording that may change over time. Do not calculate all possible measures – only those relevant for the intended purpose.

**The Information-Overload Trap**

Do not be overwhelmed by the data, so that you are unable to see hidden critical performance information. This is a common problem in data analysis – inability to see the forest and being overwhelmed by the trees.

Here is a useful rule to follow: *Do not torture the data until they confess. Know what is required for the KPI you want to measure.*

A common KPI in retail banks that may lead to another trap is the so-called risk trap. Creating a KPI to minimise risk, as is quite common, may be harmful to risk-adjusted financial performance, the preferred KPI. It is not the case that banks should minimise risk. Rather, they should maximise return for a stated level of risk tolerance. This is a different perspective. Remember that risk mitigation follows the development of the bank’s business strategy.

**Do not conduct risk mitigation procedures independent of the bank’s business strategy.**

As indicated above, the Performance Management Module has provided KPIs used in retail banking that are suitable for group performance, divisional performance as well as for individual performance. These metrics are intended to align team and individual performance with the strategic objectives of the bank.

In keeping with the logical development of this module, it is recommended that retail banking decision makers locate their business strategies within an Ansoff matrix. Hence, by logical consistency, the design of KPIs should be different for each quadrant in the matrix. We present an approach to developing KPIs that are aligned with the business strategies of a retail bank. We repeat the Ansoff matrix for reference and indicate the relevant Business development KPIs for the associated business strategy.
Clearly, there are other KPIs that are suitable for each business strategy. The key is to be logical. There is no universal KPI; that is, KPIs should be congruent with business strategy that is located in a particular quadrant of the Ansoff matrix. For example, if the retail bank chooses a market penetration strategy (existing products to existing markets), suitable KPIs should measure customer wallet penetration/cross-sales ratio/number of products per customer. This KPI measures the number of products that have been cross-sold to the customer. It is a critical ratio because it focuses on the quality of the relationship that the sales/relationship manager has established with the customer. The aim is to ensure that customers come to the bank for all their product needs and don’t open the door to competitive offerings. It is interesting to note that typical branches have a ratio of 1.2 products per customer, but the more successful ones will have ratios that are closer to 2.0 products per customer. It is extremely rare to find branches with ratios above this, but those that achieve it have typically locked in customers for long-term relationships.

A final point regarding KPIs is that metrics of financial performance should not be universally applied. This is a traditional approach in retail banking that is, arguably, incorrect. For the low-risk quadrant (market penetration), return on investment (ROI) or return on equity (ROE) are both financial KPIs. This is because ROI and ROE do not include the level of risk that is incurred in earning profit. For the low-risk quadrant, this is not a meaningful omission. Since this strategy is usually associated with expense control and efficiency initiatives to maintain product margins, measures such as total expenses as a ratio of total customer balances and cost income ratio are recommended. However, for the other quadrants – especially for the business strategy based on new products introduced into new markets – ROI and ROE are severely biased. The appropriate KPI must be a profit measure that is risk-adjusted. One such measure is risk-adjusted return on capital or RAROC.
Summary

This module considered the development and execution of business strategies in retail banking. The approach is a reverse SWOT model (i.e., TOWS) after an analysis of the macro-environment determined by a PEST analysis. The TOWS approach views strategy as a 'stretch' rather than as 'fit' of current bank's strengths and weaknesses with external opportunities and threats. The Ansoff matrix is important in clarifying the external focus that the bank has chosen. This external focus is complemented by an internal analysis of the required core competencies to meet the challenges presented by the results of the external analysis. The matching of required core competencies with existing core competencies in the retail bank creates a potential core competency gap. This is why it is essential that the bank's head of HRM join the business strategy development team. The bank's HRM team will conduct this core competency audit. If the core competency gap is substantial, the bank strategy is quite risky. It is likely that the bank has wandered off into unrelated businesses or new markets where the high sunk cost bias can lead to poor financial performance.

We emphasised the crucial link of executive strategy that connects the bank's business strategy to its financial performance. The role of appropriate KPIs is predominant to generate employee motivation and even engagement that will serve to increase the likelihood of success. This is where the bottom-up strategy development meets the top-down execution feasibility assessment and success in business strategy development is actually determined. The creation of KPIs must be logically consistent with the selected business strategy and the financial KPIs must be related to the level of risk incurred. For example, ROI and ROE are appropriate for low-risk strategies (e.g., market penetration) while RAROC is relevant for relatively risky strategies. Finally, we warned of the steep hurdle presented when the bank enters new markets that are culturally different from its home market. While other factors in the PEST model are important, cultural distance is dominant and affects customer perceptions and trust – a key factor for the success of retail banking. Entering non-home markets with new products is fraught with sources of (Knightian) uncertainty rather than just risk.
Multiple Choice Questions

1. Which quadrant in the Ansoff matrix presents the highest level of risk for a retail bank?
   a) Existing products and existing markets
   b) Existing products in new markets
   c) New products in existing markets
   d) New products in new markets

2. In conducting business strategy in retail banking, what is the recommended sequence?
   a) SWOT analysis after an application of the PEST model
   b) SWOT analysis before an application of the PEST model
   c) TOWS analysis after an application of the PEST model
   d) TOWS analysis before an application of the PEST model

3. Which statement is incorrect?
   a) A bank’s business strategy comprises its market positioning and, as a result, talent management to close a potential core competency gap.
   b) Porter refers to market positioning as ‘needs-based positioning’.
   c) A large core competency gap reflects a low risk but significant opportunity for the bank.
   d) The effective execution of a bank strategy depend on having the right people in the right jobs.

4. Which statement is incorrect?
   a) A bank’s strategy is constrained by the bank’s risk appetite statement.
   b) Basel III capital requirements for more equity capital coupled with a limiting leverage ratio will prevent banks from positioning in the relatively riskier quadrants of the Ansoff matrix.
   c) Operational excellence is an enabler of the success of the bank’s business strategy.
   d) The bank’s human capital (people skills) must be continually upgraded so as to maintain its competitive market position.

5. Which of the following is not a main source of value-creation in a bank?
   a) Operational leadership
   b) Customer intimacy
   c) Product leadership
   d) Size of the bank’s product portfolio

6. In assessing external market forces, a bank official concludes that “alternative channels in retail banks are growing at a phenomenal rate as a result of high speed online connectivity and capability. Advances in IT are expected to continue to generate substantial process efficiencies.” This statement refers to which component of the PEST model?
   a) Political
   b) Technology
   c) Social
   d) Economic
7. Micheal Watkins of the Harvard Business Review states that focusing on threats and opportunities first helps lead to productive discussions about what is happening in the external environment, rather than getting bogged down in abstract discussions about what the bank is good at or not good at. This statement is most closely linked to what approach to strategy development?

a) SWOT  
b) PEST  
c) TOWS  
d) Porter’s Five Forces Model

8. In a recent speech by the assistant governor of a central bank, it was asserted that “under the new Basel III framework, common equity requirements are significantly higher for the same level of risk-weighted assets. This will lead to reduction in available capital to do business and hence impact bank strategy.” Which one of the four quadrants of the Ansoff matrix is most impacted by the increased capital requirements of Basel III?

a) Product development  
b) Market penetration  
c) Market development  
d) Diversification

9. In a report on Investors’ Day, the head of Retail and Business Banking of the Nedbank Group stated that a key strategic focus of the business is to focus on economic profit (EP) growth. Specifically, the business endeavours to “provide high returns, low capital and liquidity consumption and reduce earnings at risk profile”. This strategic objective is best evaluated with which of the following key performance indicator (KPI) metrics for the retail and business banking business?

a) ROE  
b) RAROC  
c) ROI  
d) EP

10. In executing the bank’s business strategy, senior management must create appropriate KPIs. A KPI based on cross-selling is most likely not appropriate for which one of the four quadrants in the Ansoff Matrix?

a) Penetration  
b) Diversification  
c) Market Penetration  
d) Product Penetration

Answers:

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