



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.

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

* 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 Wehrich in 1982 in a paper in *Long Range Planning*



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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.

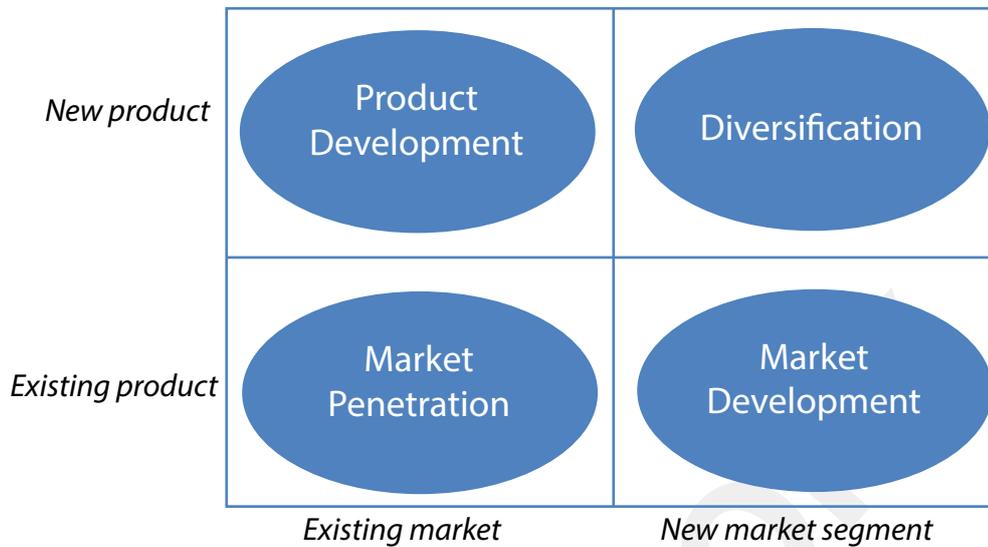
This is the objective of strategic market research – assessment of the profitability potential of a new market segment that could be addressed by existing or new products or the development of new products that would address the needs of customers in an existing[†] market segment.

* 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'

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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

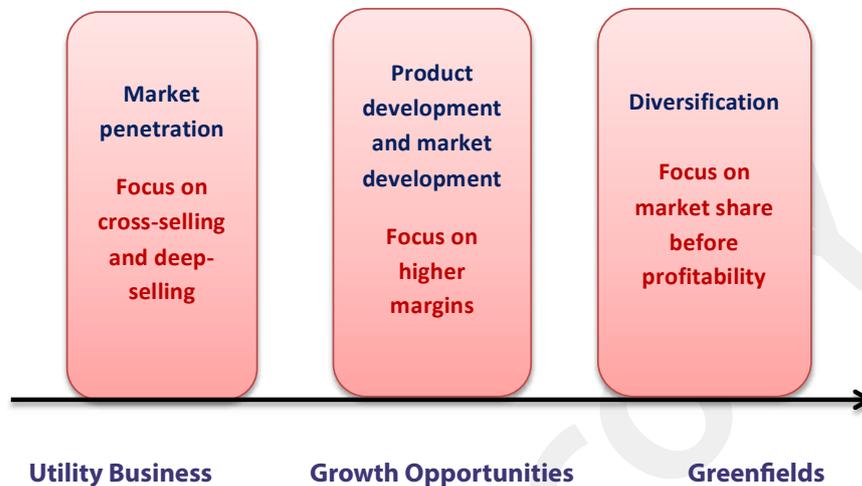
† The next module will deal with strategies to achieve profitable growth



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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.

*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



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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.

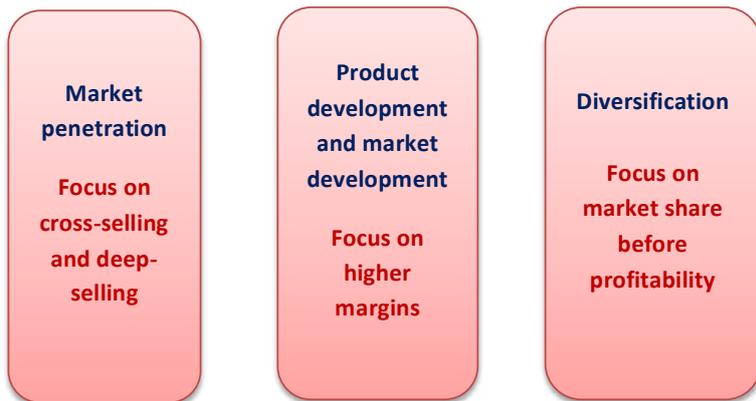
If the core competency gap is large, the bank may not be able to deliver on its strategic objectives: it is a sign that the bank has strayed from its core business. An extensive hiring programme to reduce the core competence gap is not feasible, nor is it recommended. Instead, decision makers should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

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302.3: Core Competency Gap

In the following excerpt, we reiterate the main features of a core competency for retail banking based on the general precepts proposed by Hamel and Prahalad (1990) – *a core competency has relevance, depth and breadth of application.*

First, and obviously, the core competency must be relevant to banking. For example, a high degree of professionalism and ethical steadfastness would likely persuade the customer to deal with the bank.

Second, a core competence is difficult to imitate and, by continual development, establishes a source of competitive advantage. In a retail banking context, competitive advantage is summarised in the bank brand that signals principled leadership to all stakeholders; high degree of risk and capital management expertise especially in dealing with greenfields and so on. This means that a core competency has depth.

Third, a core competency has *breadth* in that it could apply at any stage of the time-horizon model or in any quadrant of the Ansoff matrix. This is a key feature of core competency that is different from non-core skills. Core competency is general enough to meet the challenges of any stage in the time-horizon model. Non-core skills are important but less malleable and more specific in the match with a job function.

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



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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; Crouzille et al., 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; Al-sharkas 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.

* “Mergers and acquisitions: the Nigerian banking consolidation program” by Chukwuma Agu, A, Damilola Olajide, Divine Ikenwilo and Anthony Orji, *International Journal of Banking and Finance* (2012)

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