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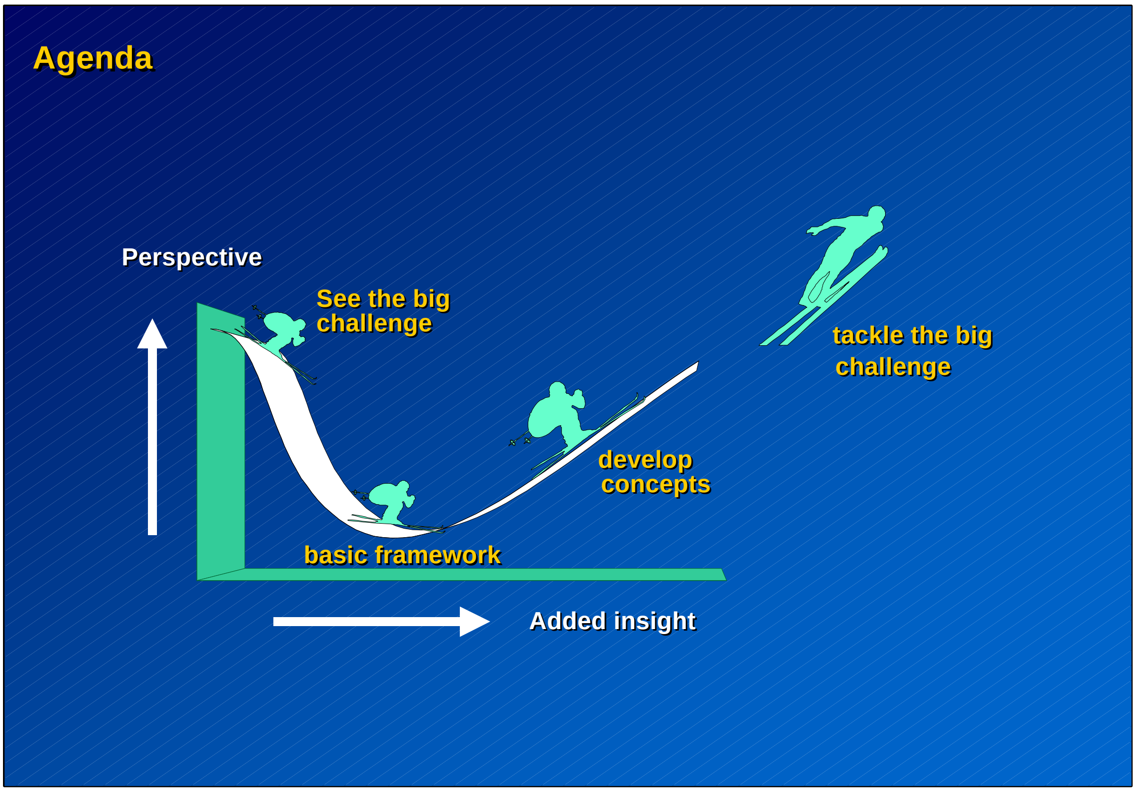
[The retail bank e-business strategy, described here, also forms part of a separate document on Scenario Dynamics, presented to the April 01 Visa Europe Members Conference, at www.strategydynamics.com]

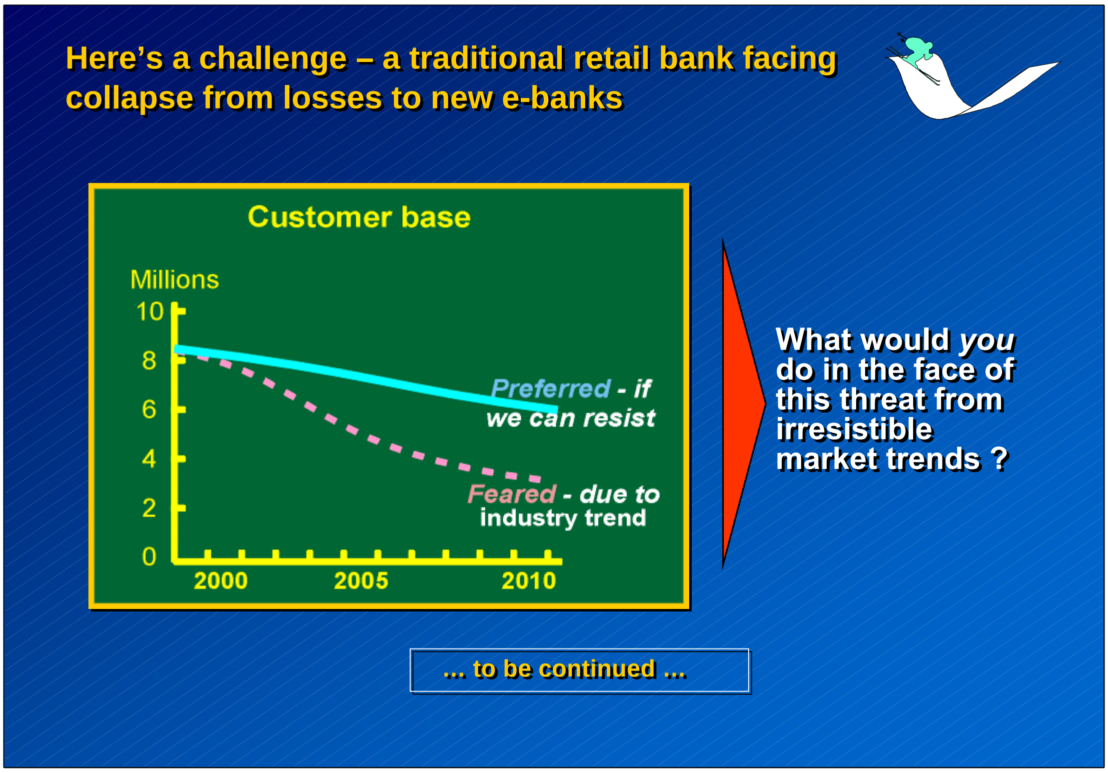


The challenges facing executives with strategic responsibility (whether the President of Cisco, the head of the Health Service, or the entrepreneur) are large, complex, subtle and constantly changing.

There are no simple answers, so the route to your answer must be built up from solid fundamentals.

Agenda

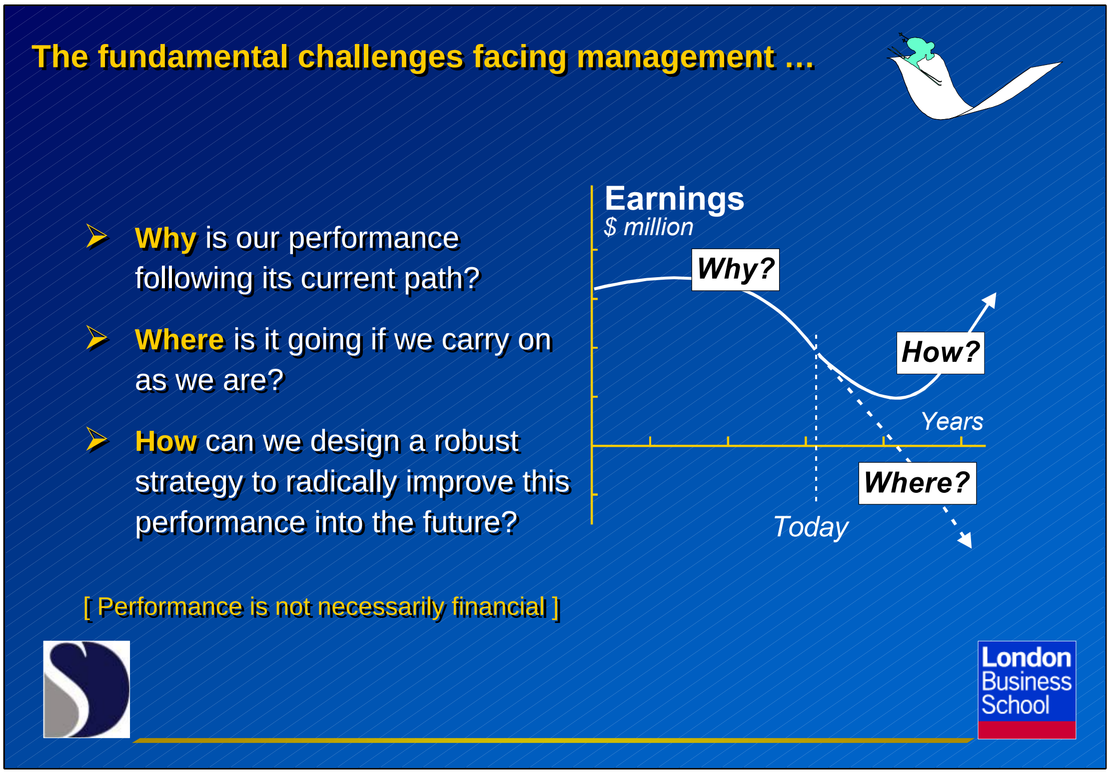
- The Strategic Management Challenge
- Core Principles of Strategy Dynamics
- Tackling rivalry
- Tackling soft issues
- A major case – defeating the e-Banks



To set the scene, consider a challenge facing many established retail banks, who see their business being taken by frisky young e-banks:

- they have none of the burden of branch assets or heavy overhead to slow them down.
- demographic, social and technological trends are working in their favour
- and the old firms have a boring reputation

It's no good just telling management to start their own e-bank – someone *still* has to tackle this problem.

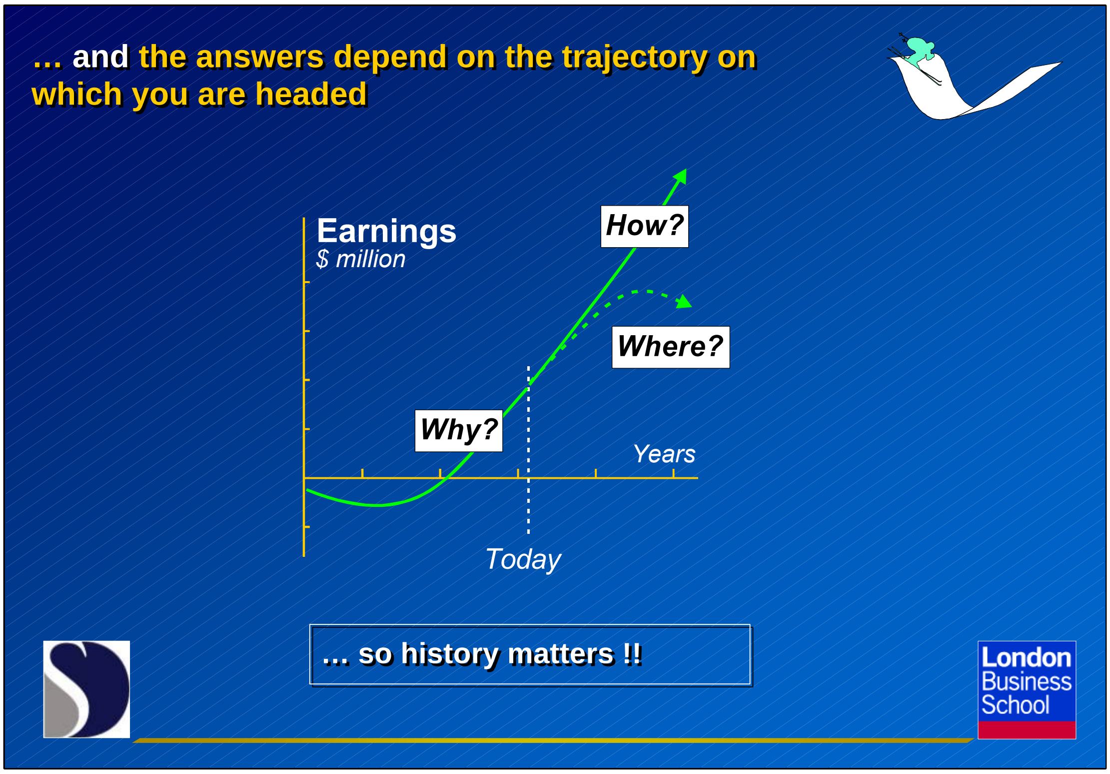


These are near-universal expectations that face top management – they, and their investors, expect the organisation's performance to progress strongly through time.

- There is some historical performance path, that needs to be understood. The organisation is headed on a trajectory into the future, caused by changes that are already in progress, and this path contains information on why the organisation performs as it does. *(Only for completely new businesses is this history not applicable).*
- Those processes of change, both from within the organisation and from outside, will push performance in a certain direction, unless management acts to change the future.
- Management is expected to work out how they can improve the future, relative to what it would otherwise be, and continuously update this understanding.

For non-profit organisations, such as charities or governmental bodies, the challenge of performance over time is still fundamental, though it may be expressed in non-financial terms, e.g. number of beneficiaries served, service-levels delivered, etc.

These questions are so fundamental to management and investors that you might expect to find them addressed in most Strategy books. However, charts of this form (performance over time) are almost never to be found.



The answers to these three questions are *always* specific to each particular case. It is quite possible to have two organisations with exactly the same performance at one moment, but each headed in different directions – e.g. one is winning customers each week, while the other is losing them.

History matters, because decisions and other causes of change take time to operate, for example:

- Sega's decision to cut prices on its Dreamcast games console quite slowly during its first year on the market affected its sales rate – which is still reflected today in the subsequent sales rate for games.
- The high bids from some telecoms firms for 3G mobile phone licenses is reflected today in the rate at which these firms are investing in new infrastructure, which in turn will be reflected in the rate at which consumers adopt the service.
- Exxon's pressure to have the US government reject the Kyoto accord on cutting emissions of greenhouse gases is reflected in their public reputation, which in part accounts for today's rate of gasoline sales.

Key points to note about this approach :

- the method is do-able, but demanding
- it builds on established approaches to strategy, plus the well-defined 'method' known as system dynamics.

Agenda

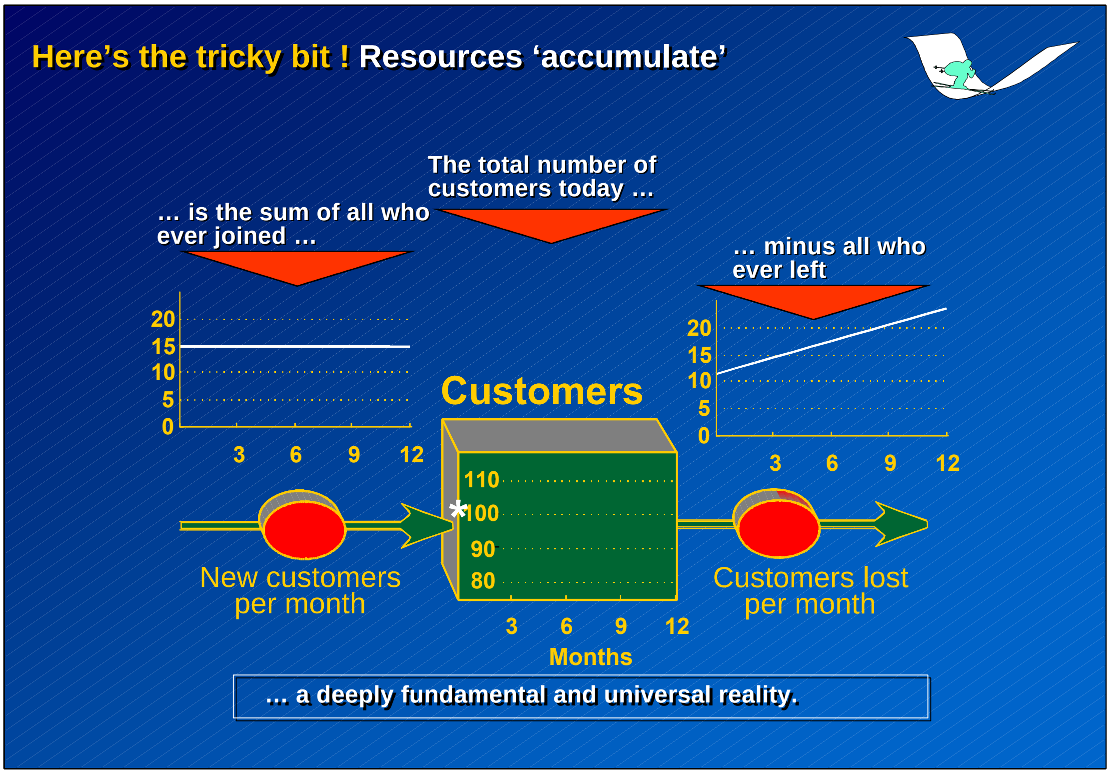
The Strategic Management Challenge

Core Principles of Strategy Dynamics

Tackling rivalry

Tackling soft issues

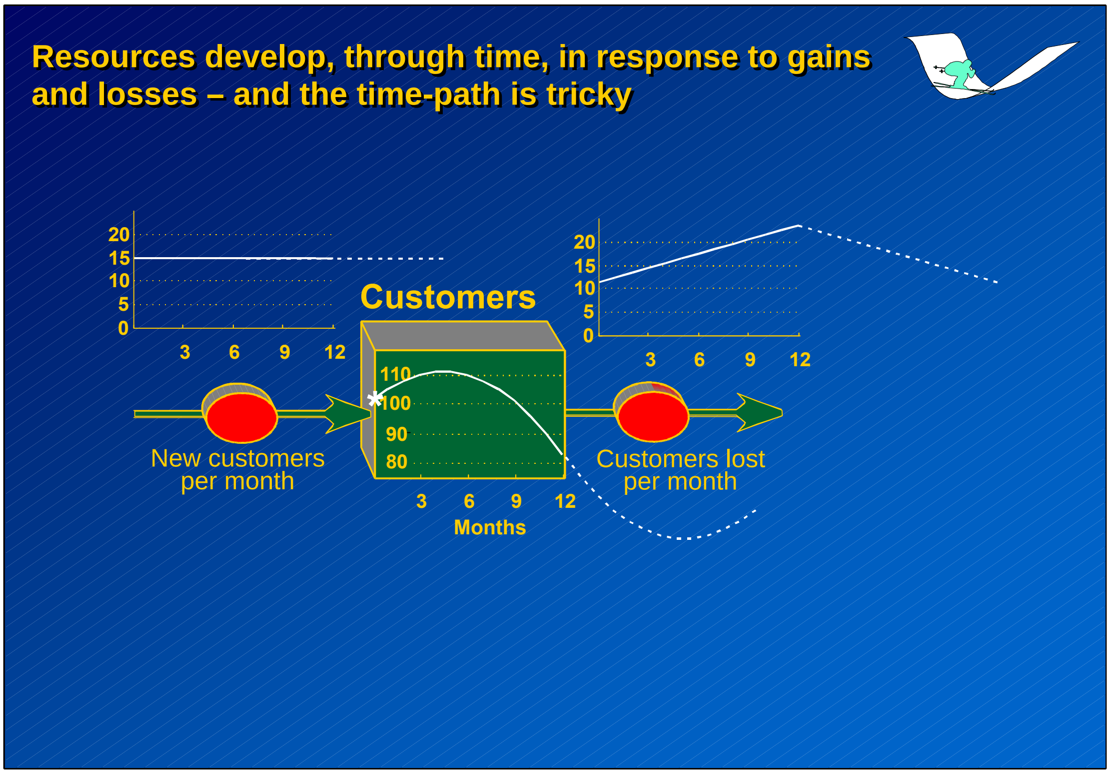
A major case – defeating the e-Banks



The fundamental building-block of the Strategy Dynamics method is the notion that certain items, especially resources and capabilities 'accumulate' and 'deplete' through time – like water filling a bath. Standard approaches to management and policy fail to take this fundamental feature of reality into account.

This process is widely misunderstood, e.g. world leaders have not (as they often claim) been discussing how to 'cut greenhouse gases' – they have been talking about cutting the *rate at which we are increasing them.*

All resources and capabilities exhibit this behaviour, best thought of by analogy to a bath-tub. The quantity of water in a bath is the sum of all the water that has ever flowed in through the taps, minus all the water that has ever flowed out through the plug-hole.

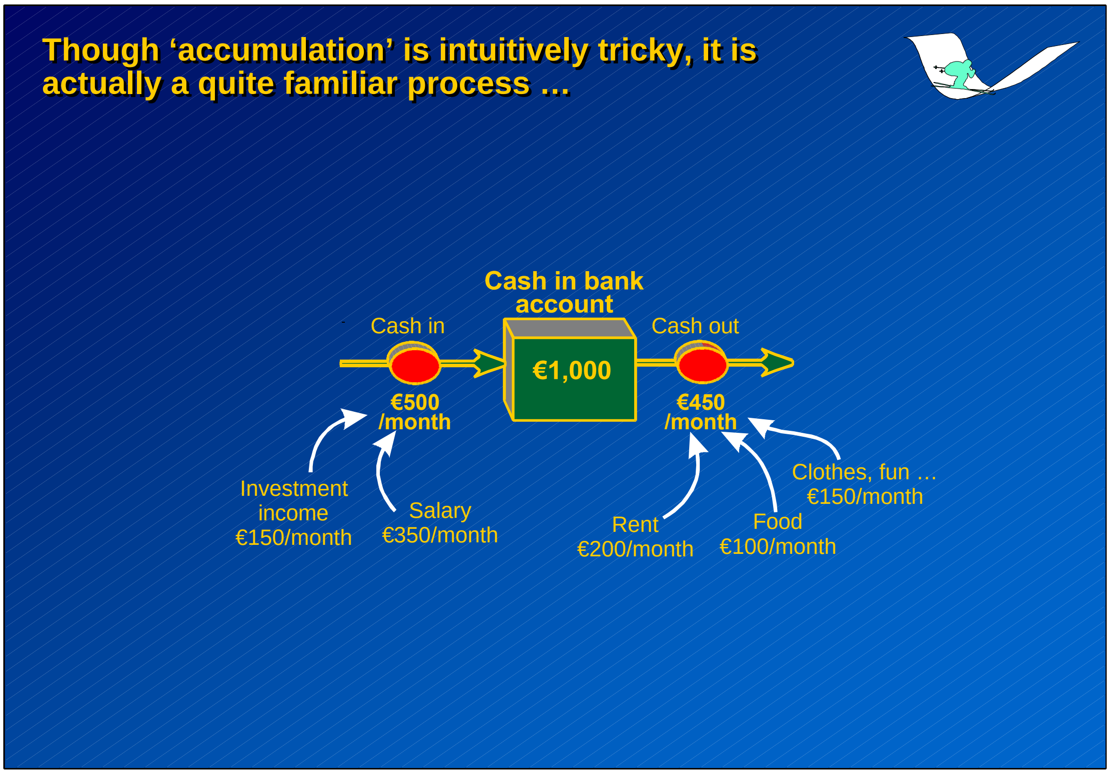


The idea of things building up and draining away over time sound easy enough, but the process creates changes through time that are not intuitively easy to grasp. Most people, faced with these rates of customer gain and loss, will not estimate correctly how the stock of customers changes through time. Even those who get the shape of the curve right rarely estimate the actual numbers correctly.

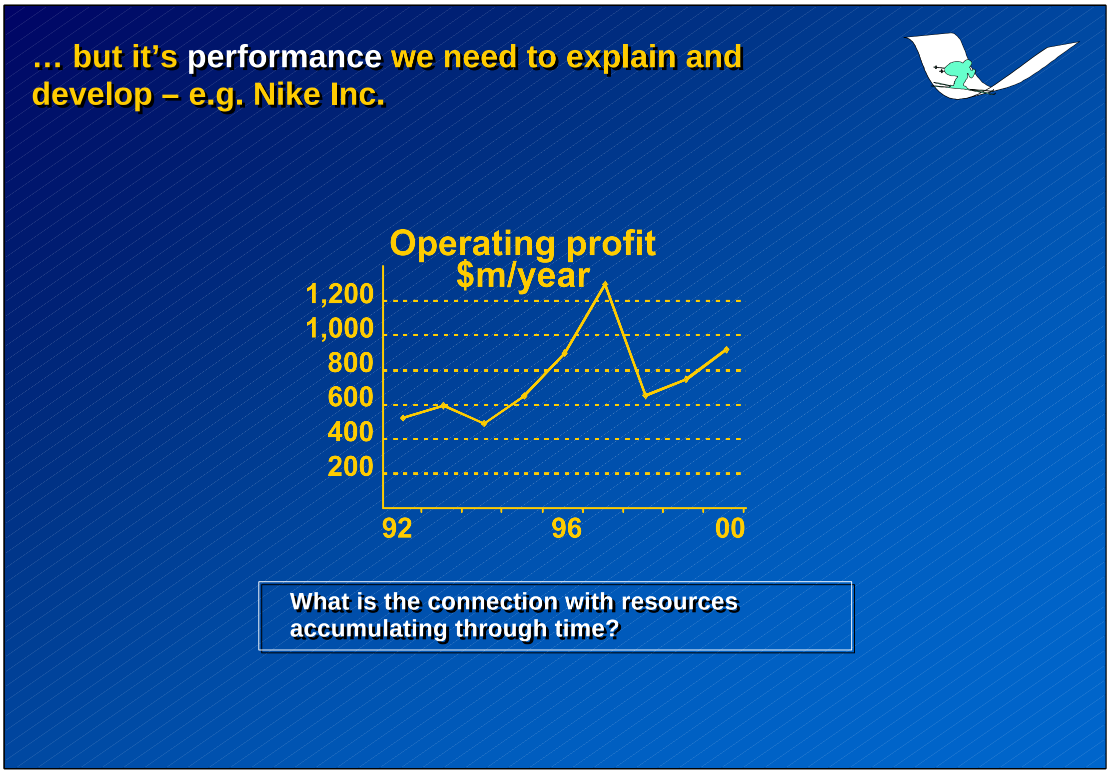
- This is serious, because if performance depends on things that are changing like this, and most people don't understand *how* these changes are playing out, the chance of estimating performance into the future is very poor.

- If you find this tough, imagine how difficult it is to anticipate what is happening, for example, to numbers of staff, when they are moving 'from tank to tank' (juniors to managers to directors) and the 'flows' of people into, between, and out of each tank is changing through time.

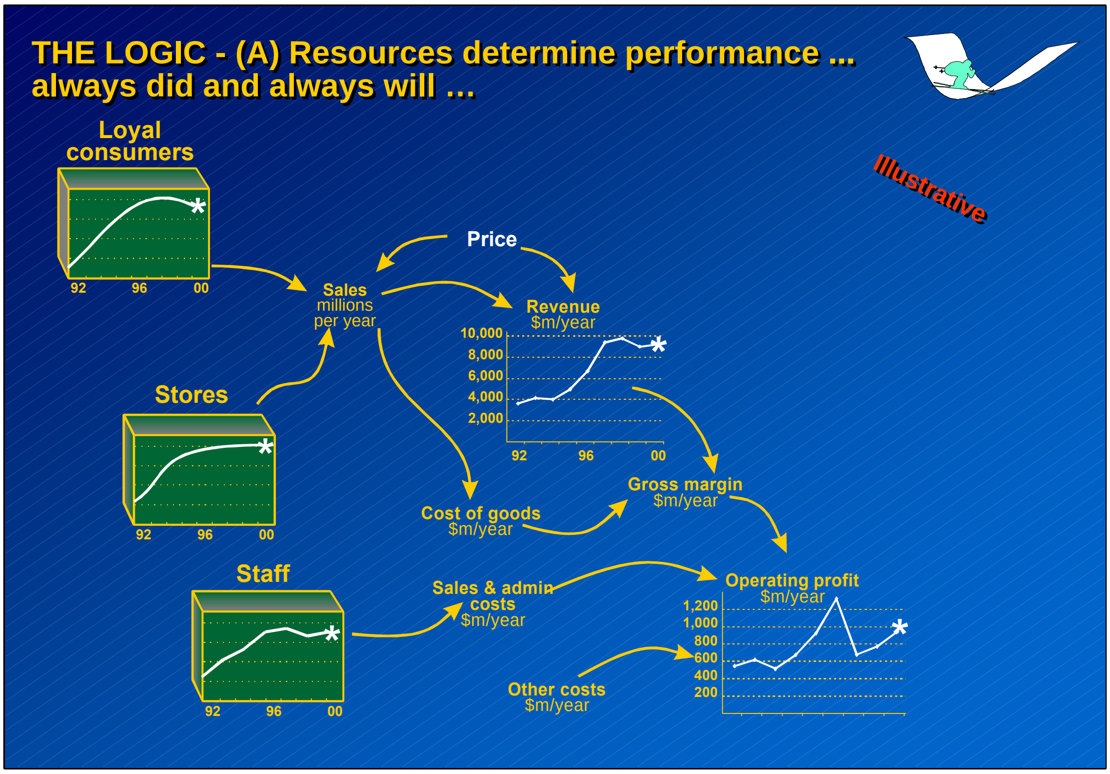
- The maths gets *very* tricky, and the education most of us received through school mostly ignores this process.



In spite of the intuitive challenge of understanding how resources build and deplete, the process is quite familiar – we manage the flow of money into and out of our bank account, for example, without losing control, and most of us can run a bath without having it overflow!

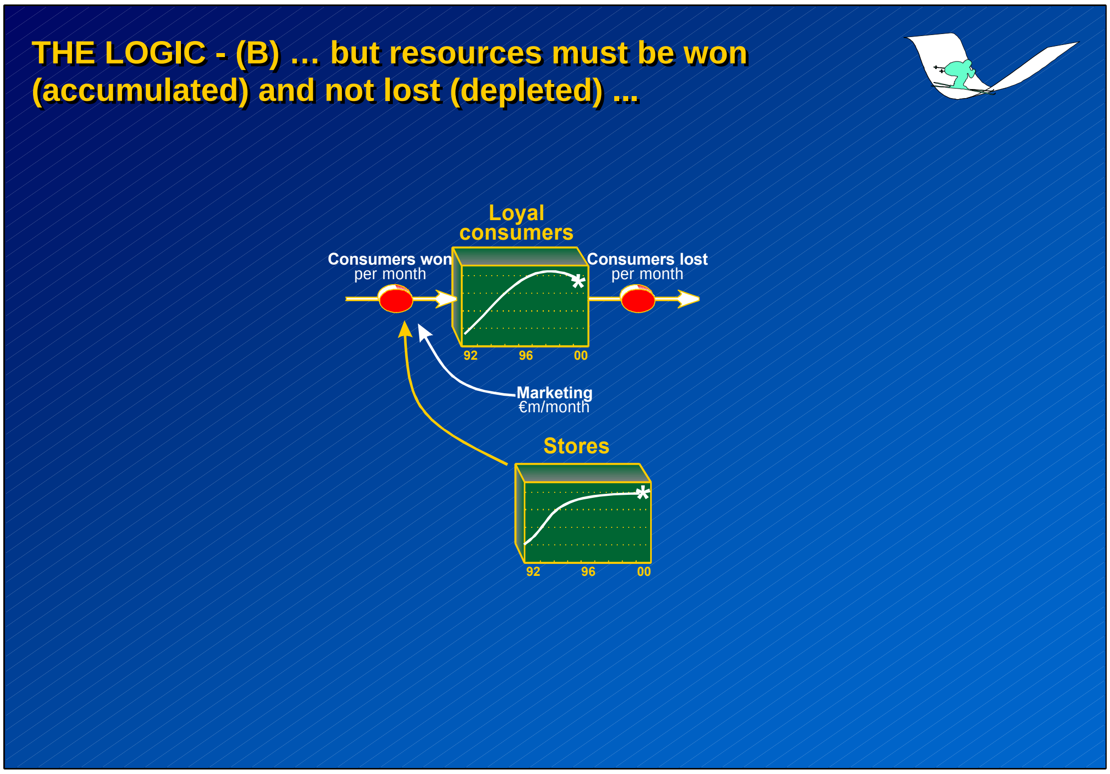


There is a gap to bridge between the behaviour of business resources and the performance path that investors are interested in. Take for example this performance path for Nike.



This performance path for Nike depends on the simplified relationships on this slide. Tracking back through these causal links gets us to the consumers who prefer to buy Nikes, stores that stock them and Nike's staff (and other resources) :

- Although consumers and stores are not 'owned' by Nike, they are nevertheless reliable, and therefore part of the system – there is a good chance that most of them will still be with this firm next month, next quarter, or even next year.
- Nike has to have both consumers *and* stores (or other channel resources) if it is to sell its shoes. Its sales can be estimated closely if these two resource quantities are known.
- Its costs are known, given the number of staff – and other internal resources.

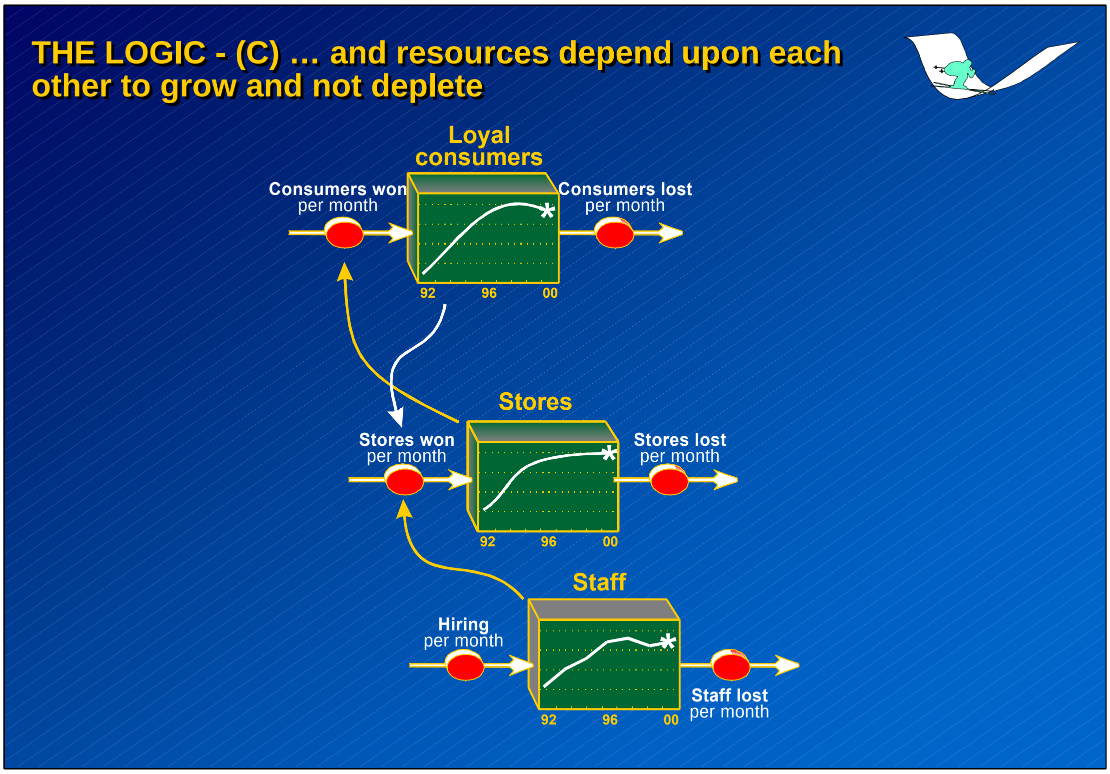


To build the stock of loyal consumers, Nike can use:

- cash, which is spent on marketing,
- the stores, who make the shoes visible to consumers,

The more stores stock the brand, the faster consumers are won. This process slows as more and more potential consumers are developed –it simply gets harder to find the few people who remain. Also useful are its reputation for quality and coolness, and the stock of consumers who are already loyal to the brand, which drives *more* new consumers through word-of-mouth.

Resources can *only* be built by making use of existing resources that are available. This even applies to entrepreneurs, who must have credibility and confidence if they are to win investment and the key people necessary to get their business started.

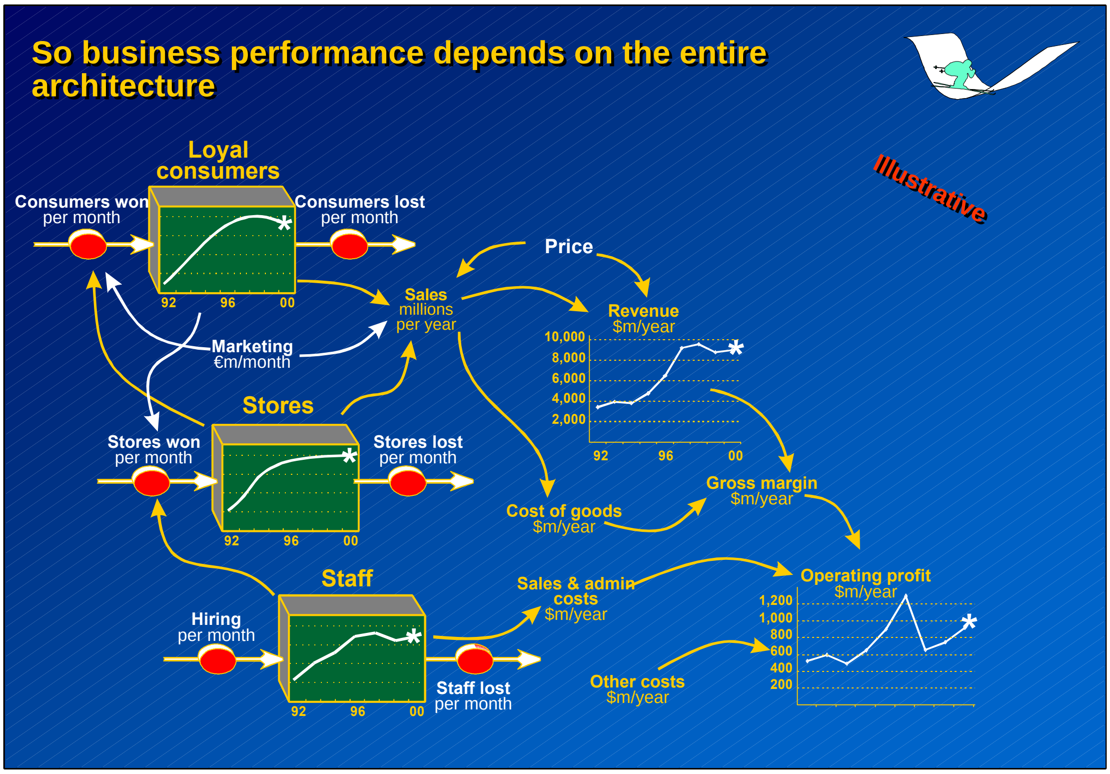


All these resources for Nike behave like the bath-tubs described earlier. Numbers of staff, consumers and stores at any moment are not ‘related’ to anything – they are always precisely the sum of everything ever won, minus everything ever lost.

And the rate at which each grows depends on the quantities that already exist:

- the rate at which stores can be acquired depends on the number of sales staff who are available to sell to them, but
- those sales people will only be successful at winning stores if a large enough number of consumers want Nike shoes to make it likely that the stores will make good money from stocking them.

Since growth of stores depends on numbers of consumers, and growth of consumers depends on the number of stores, there is *feedback* amongst these resources.



Putting these pieces together builds a picture of the firm's 'strategic architecture':

- the performance at any time and all times is explained by the quantities of resources that exist,
- those resources accumulate and deplete over time,
- … and depend on each other to grow.

The resource-flows are the *only* place where management can make any difference to the organisation's fundamental performance. Whilst expenditures can be raised and lowered quickly, these decisions will only affect *future* performance by changing the flow of resources. These flows are also the only place where outside forces can affect future performance – e.g. if economic conditions hit consumers purchase rate, or rivals tempt your best staff away.

This interdependent system of resources is the heart of every enterprise, where 'interdependence' arises from the feedback amongst those resources. 'Performance' is not, in itself, the business – performance hangs off the side of the true core of the business.

We can have whatever mental model we like about what is going on, but (e.g.) Nike's staff are leaving at a certain rate, for their own reasons, and stores have their own motivations for deciding to stock the products – our task, then, is to discover as best we can what those relationships are.

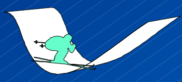
Resources … useful items, to which we have reasonably reliable access

Examples of resources

Tangible	Intangible	Indirect
Products	Product quality	Staff morale
Production capacity	Production cost-efficiency	Reputation with investors
Staff	Staff skills	Reputation with customers
Cash	Borrowing capacity	
Customers	Customer-perceived quality	
	Supplier relationships	

Identifying resources can be tricky, especially when it comes to ‘soft’ issues like staff skills and reputation. These intangible and indirect factors cannot be ignored – e.g. the out-flow of staff reflects the level of their morale at any moment, the loss-rate of customers depends on product quality, and the ability to raise cash will depend on our reputation with investors.

Identifying resources - Tips

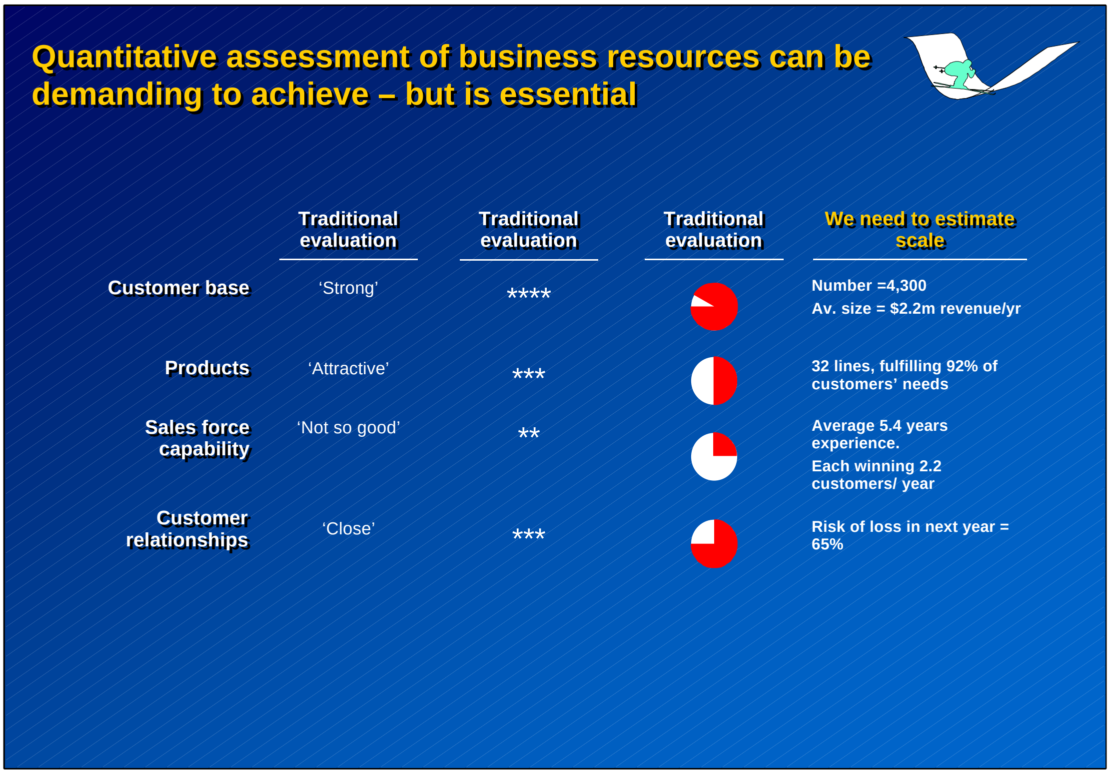


- **Some resources will be from the 'demand side'** (customers, dealers …)
- **… and many from the 'supply side'** (capacity, products, staff, cash)
- **Soft 'attributes' of tangible resources are commonly important** (staff skills, product functionality, customer size)
- **'Indirect' resources are attitudes of key groups** (notably customers, staff and investors)

Resources are NOT

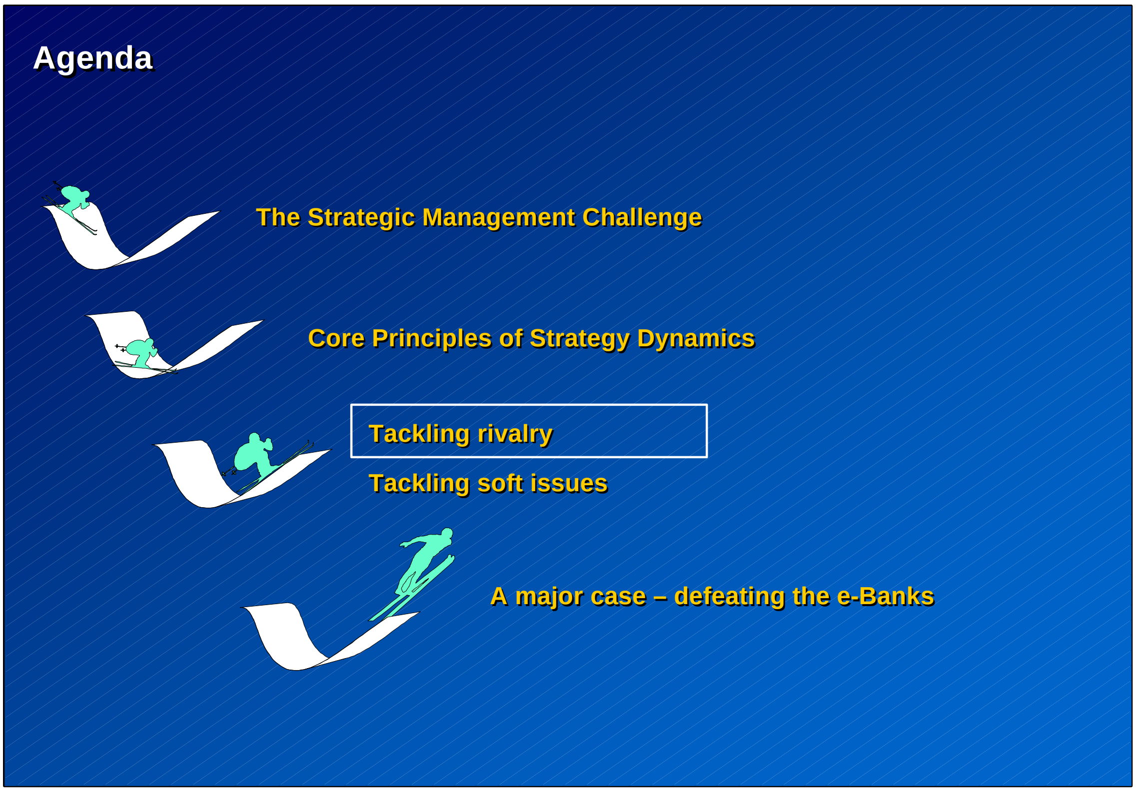
- **… profit & loss items** (revenue, cash flow) – these are 'flows' of money
- **… ratios** (market share, return on sales) – ratios are derived measures
- **… capabilities** (marketing, product development, production) – these are what we are good at doing
- **… ambiguous or abstract concepts** ('leadership', 'market power' …)

Research and articles on management feature an unfortunate tendency to use abstract, inconsistent language – not a sound basis for building understanding. 'Resources' are rather simple items - their distinctive feature is that they all behave like the bath-tubs described earlier.



It is only possible to estimate how things are changing over time if the *scale* of things is understood – so there is no choice but to put numbers on resources, and every other item in the business system.

Organisations increasingly track numbers for even the most intangible issues, like staff morale and customer reputation. Nevertheless, it is usual to discover that amongst the large quantities of information that are kept, critical items are missing – e.g. staff resignation rates, or success rates in winning new customers.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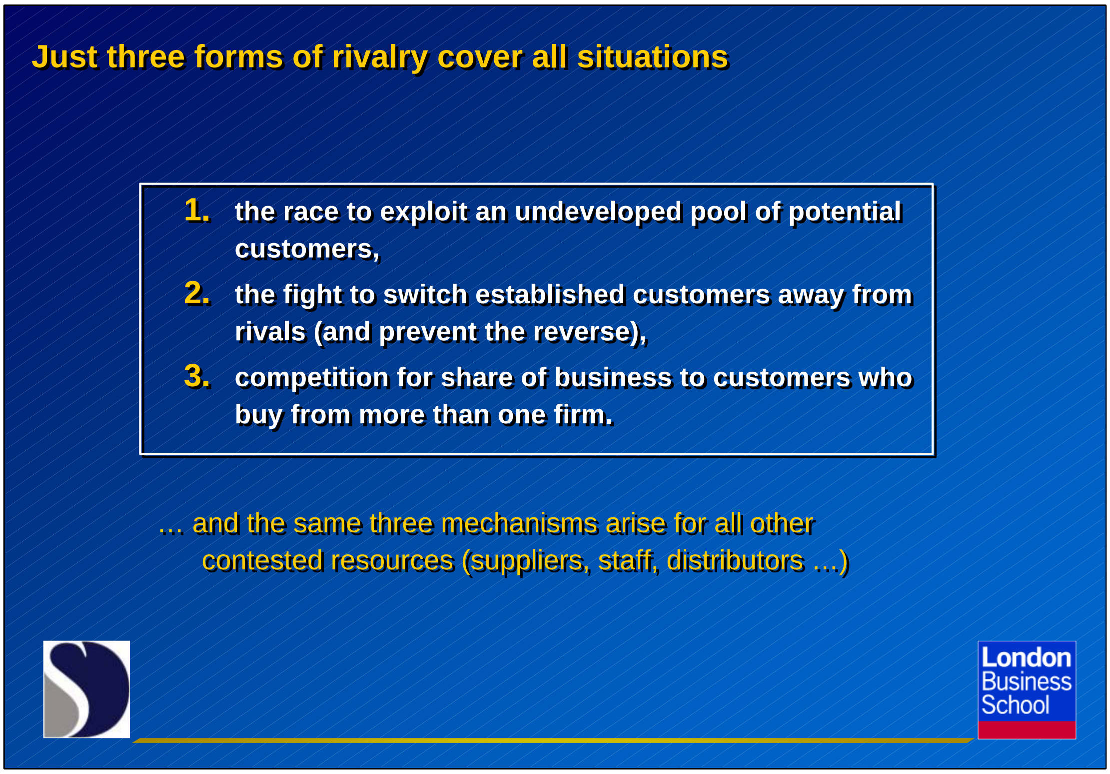
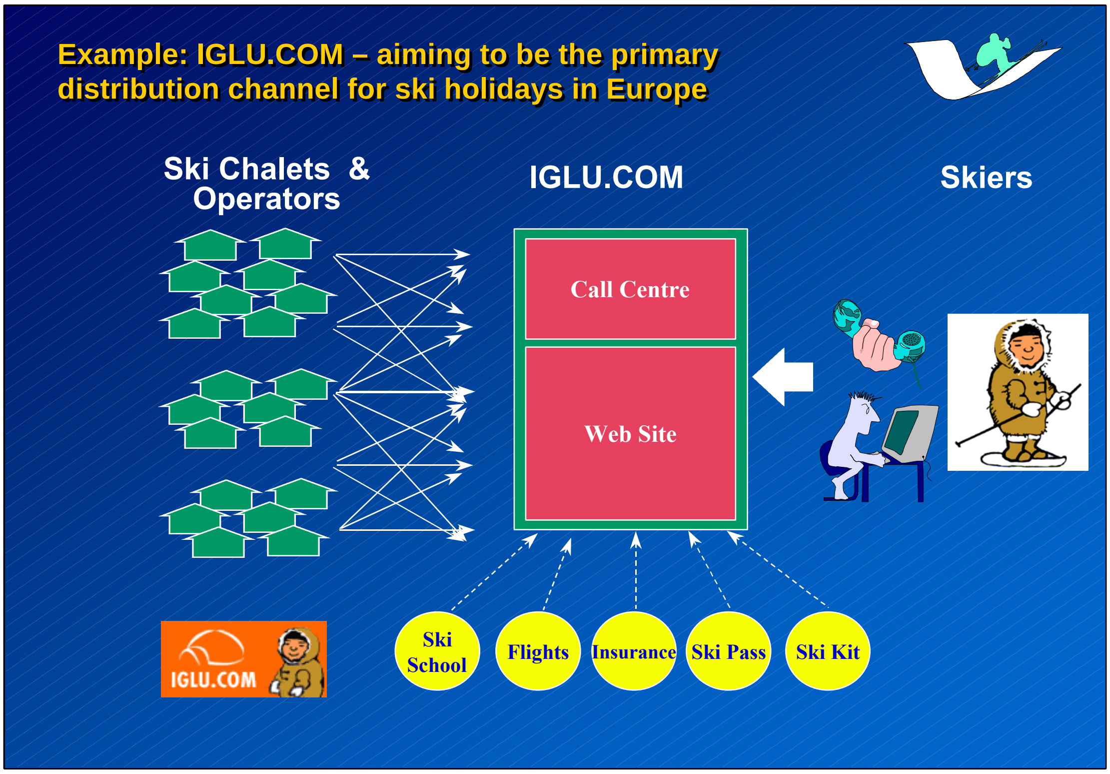


Competition of some kind features in just about every organisation's performance, and all rivalry processes are covered by these three mechanisms. Since many types of resource can be fought for, rivalry is just as relevant to non-profit organisations as it is to commercial firms:

- public services compete to win and retain staff,
- charities compete for the loyalty of donors,
- political parties compete for the commitment of voters.

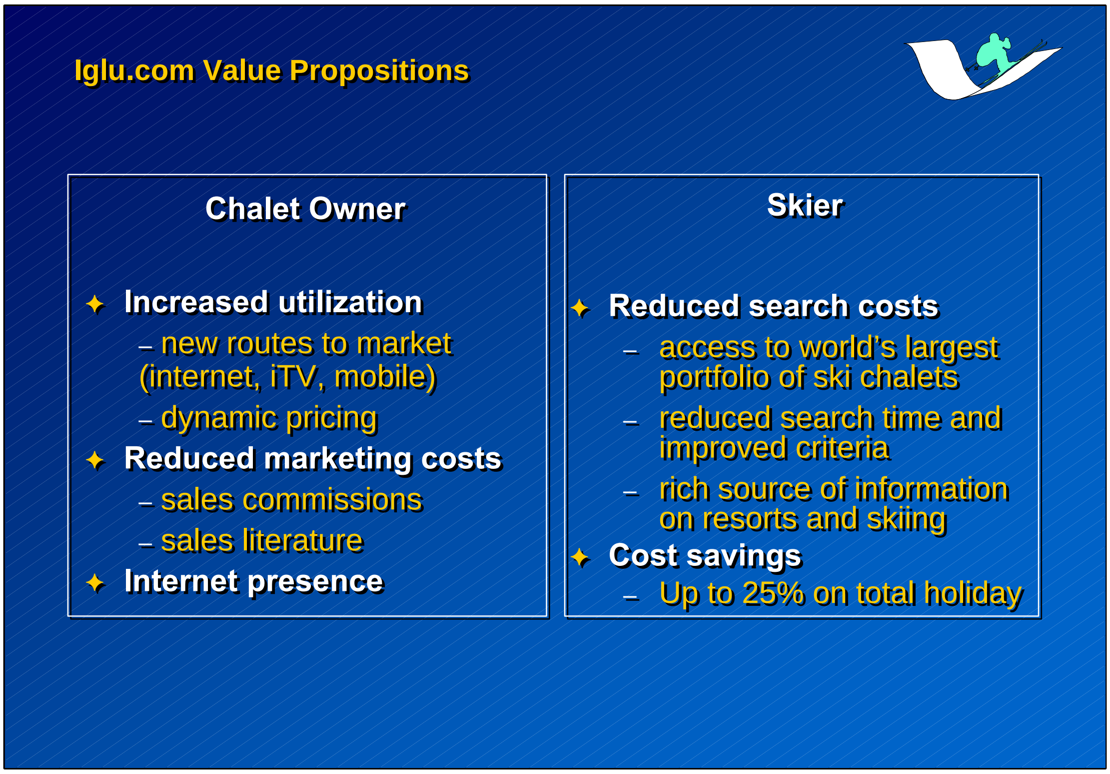


The start-up of Iglu.Com illustrates two important rivalry mechanisms. The Company was founded to exploit an opportunity arising from the inefficiency of the existing market for medium-haul ski holidays – e.g. N Europe to the Alps.

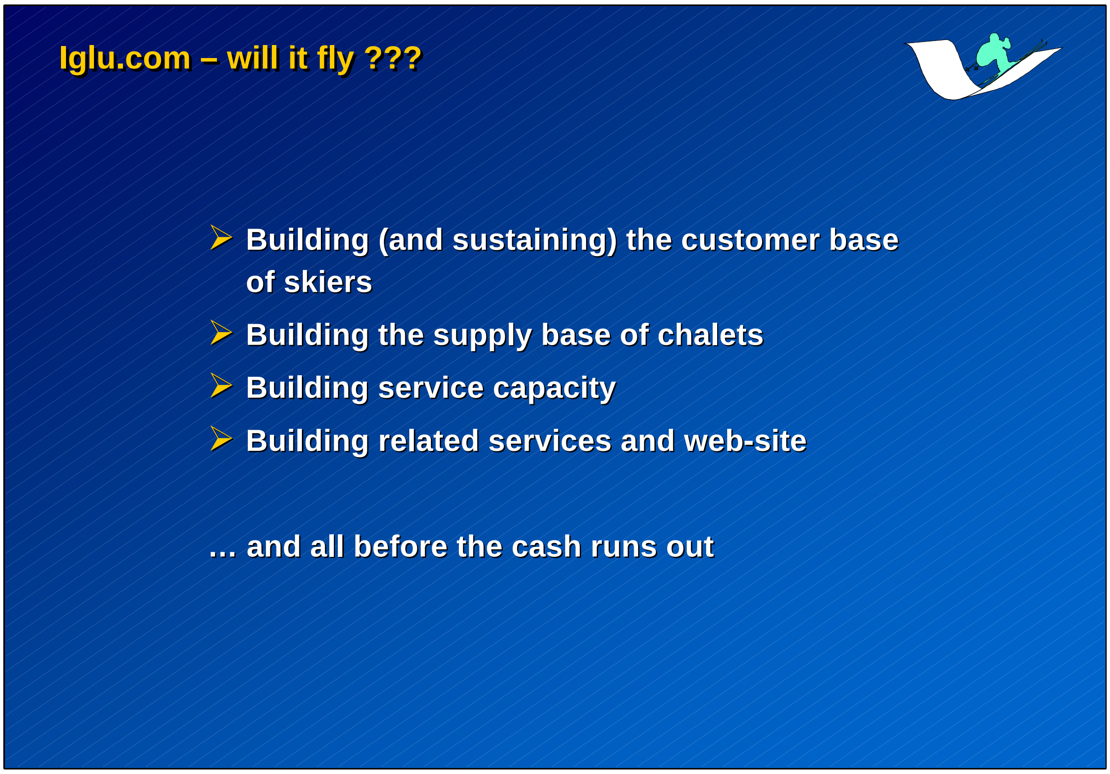
- There is a large number of owner-operated chalets,
- there is a large number of would-be skiers, and
- there are many related products and services that have to be put together to provide someone with a ski-holiday.

This complexity is currently handled by large holiday firms who 'bundle' these service, but this process is very costly, vulnerable to mismatching capacity vs. demand, and unlikely to create a strong fit between the individual skier's needs and the specific package put together by the holiday company

Iglu.Com signs up chalet-owners who provide details of their accommodation to the web-site, and supports this with a call-centre of staff trained both to answer queries that the web-site cannot handle and to close the sale to would-be skiers.



Both chalet-owners and skiers may obtain significant benefits, compared with existing arrangements. However, existing holiday firms will not ignore this threat, nor the opportunity the Web offers to improve the service they offer and the cost-effectiveness of their operations.

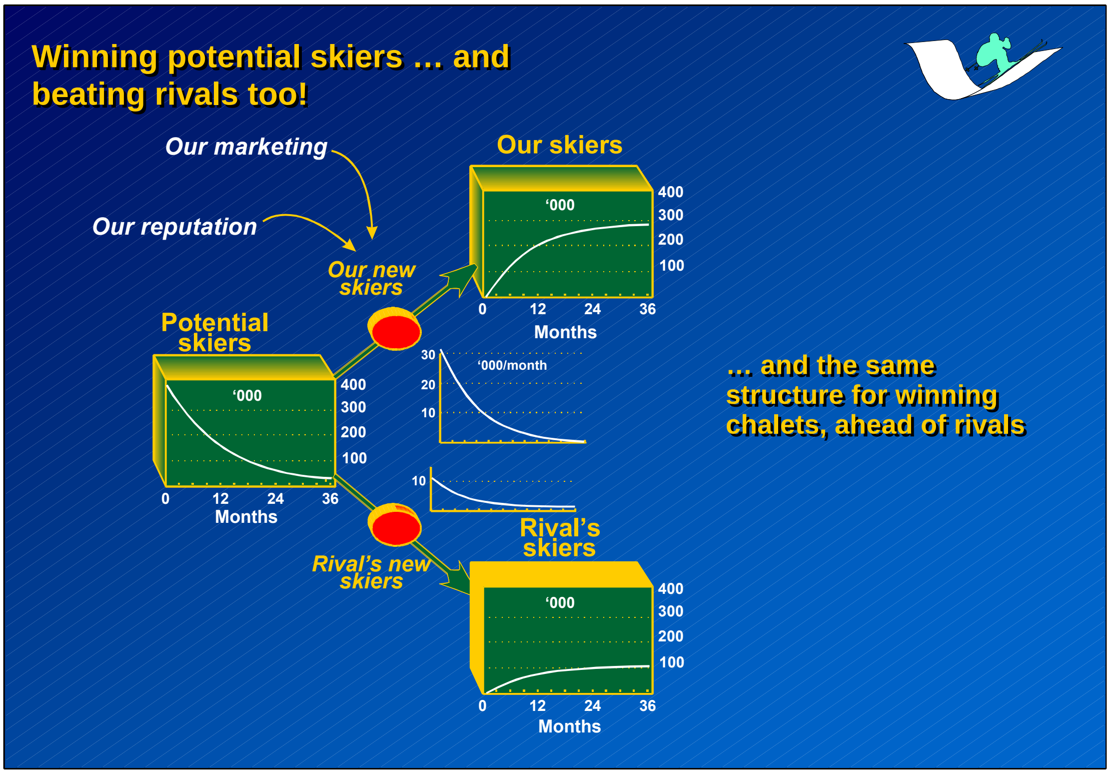


As in all start-ups, Iglu's initial 'system' is virtually empty, apart from the knowledge of the senior team and their credibility with potential investors. All of the resources above have to be built up. Having sold the business case to venture capital providers, Iglu must quickly …

- undertake heavy, but focused marketing to win skiers,
- start rapid sales effort to sign up chalets,
- recruit and train staff, and provide basic operating systems and infrastructure,
- design and extend the web-site, as well as capture, enter, maintain and update the information

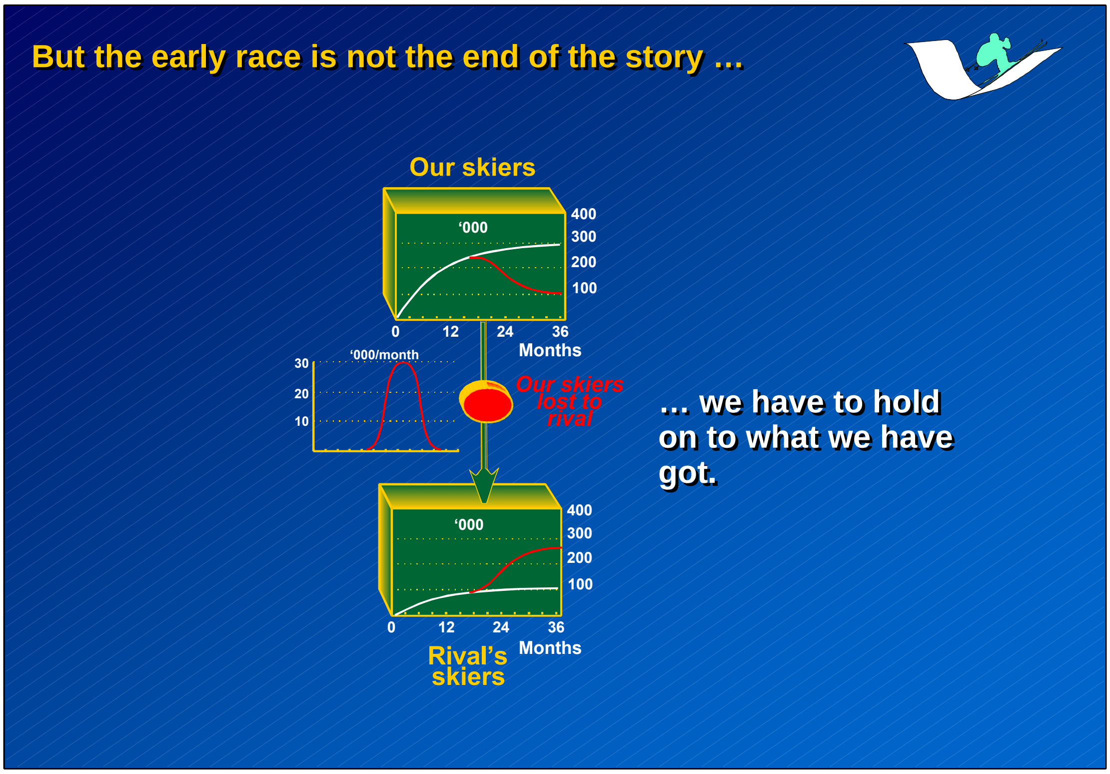
These resource-building activities are all costly, so the initial cash drains away, and needs to be replenished with further rounds of funding. As each resource is built, it costs *more* money simply to keep in existence (staff salaries, office costs …)

Finally, Iglu faces the challenge of holding on to these resources once they have been built – keeping chalet-owners, skiers and staff, against the many forces tempting them to leave is tough!



This is type-1 rivalry – racing to win customers. The opportunity is essentially simple. The faster customers are won by Iglu, the fewer uncommitted *potential* customers remain for our competitors to capture. Both their win-rate and our own will inevitably slow-down, but the end situation will hopefully stabilise with Iglu being ahead.

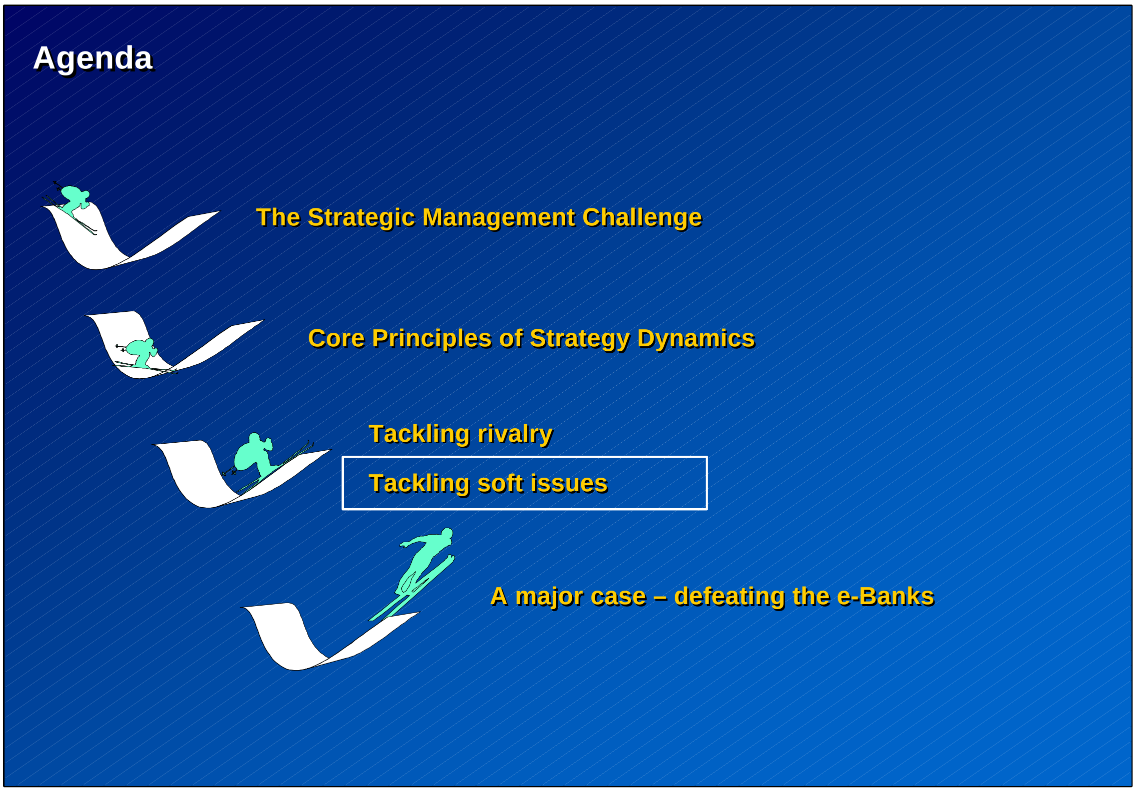
In this case, as in most others, there is also an in-flow (not shown) to the stock of potential customers – new people taking up skiing for the first time, so the imperative to keep capturing people from this pool continues.



Once the potential customers have been won, Iglu faces the challenge of protecting them from capture by competitors (type-2 rivalry). This might either arise because:

- Iglu gives them reason to go elsewhere, by failing to offer what it promises or the skiers expect (poor chalets, too few chalets, too high prices, web-site failures, unhelpful call centre service …), or
- … rivals give them reason to go elsewhere, by offering still better service than Iglu, or a cheaper price (but they will have to persuade these skiers that they are preferable before these customers have any experience to go on).

Finally (not shown) Iglu has to ensure that those skiers who use two or more services to book holidays make *more* of their bookings with Iglu than with others (type-3 rivalry). This is less likely to be an issue with such an infrequent purchase as a holiday, but will be a dominant mechanism for more frequent purchases, such as fast-moving consumer goods.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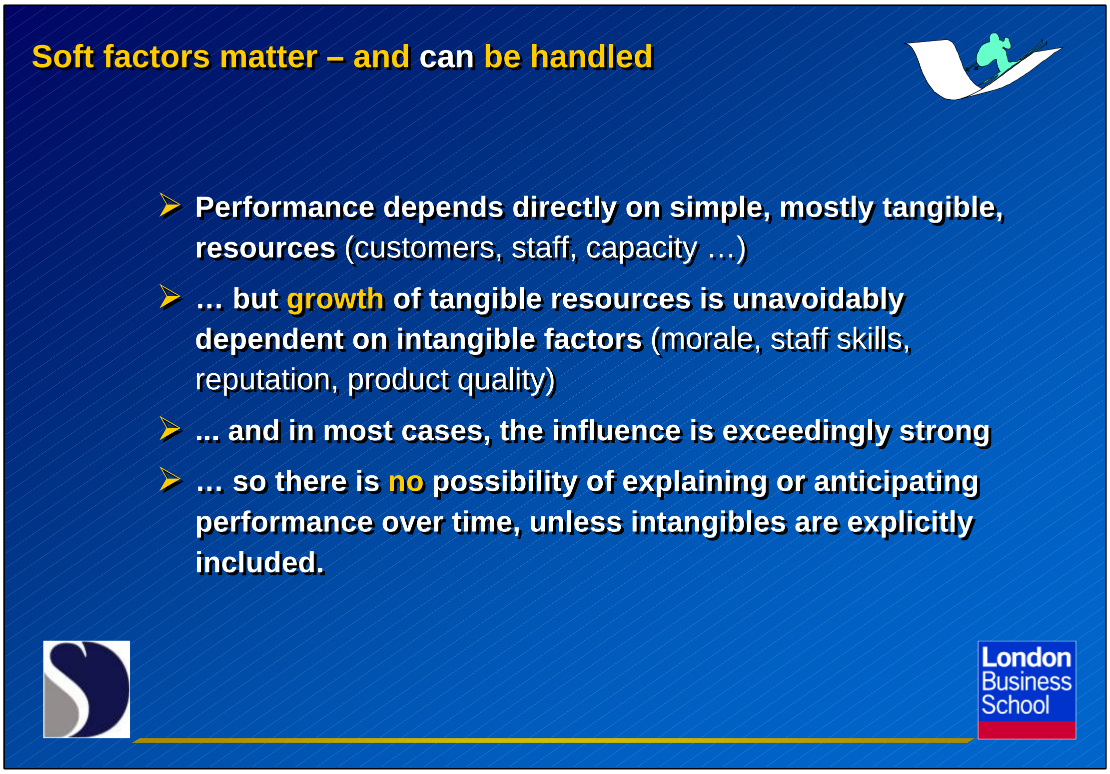
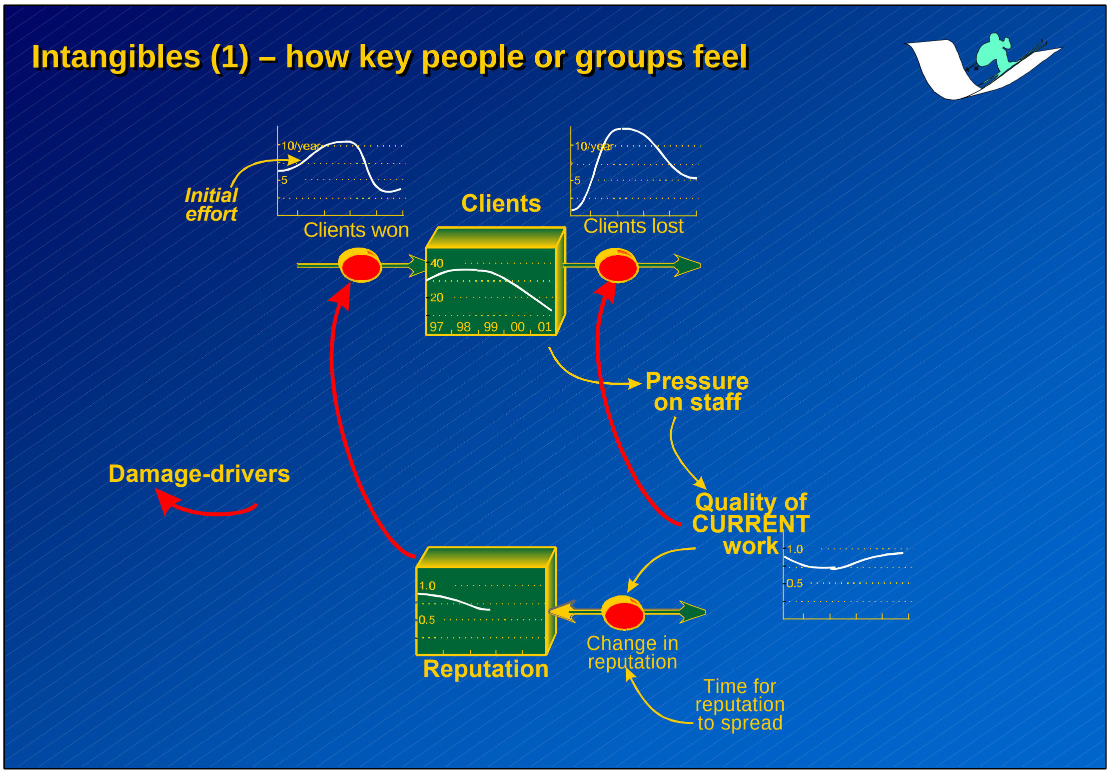


Many consultants exclude intangible factors from strategy advice to clients because, it is claimed, they are not detectable, measurable or manageable. None of these charges is accurate:

- The energy in an organisation where people feel motivated is quite different than when staff are under pressure. Any sales person can describe the customer's reaction when they try to sell a product with a worse reputation than its alternative.

- Softer issues are now regularly measured – surveys of staff opinion, customer attitudes and investor sentiment are regularly tracked. All that is missing in most cases is a clear link between changes to these critical variables and the substantive performance of the business – executives know these factors are important, but need better tools to understand and influence them.

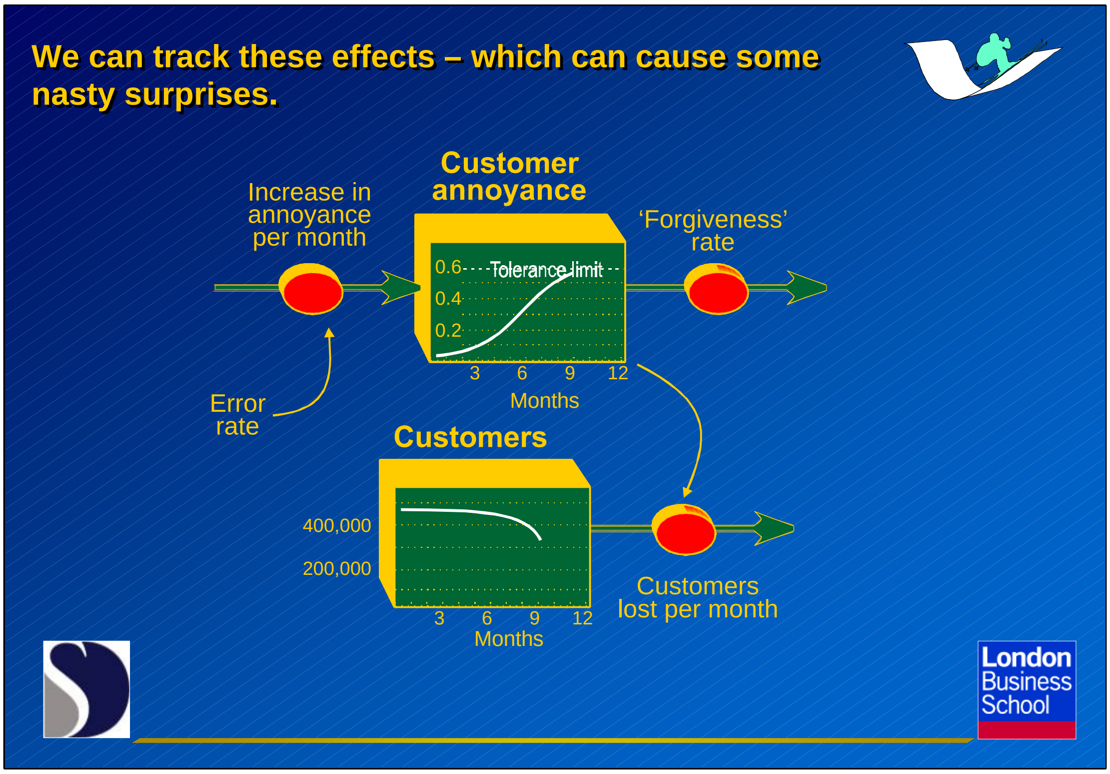
- The achievements of exemplary managers in difficult situations show that intangibles are not unmanageable. Strong operational managers can build and sustain product quality and plant efficiency, inspirational sales managers build sales force morale, and capable chief executives reassure anxious investors.



This software firm created its own performance disaster by mismanaging some intangibles:

- From a successful base, management tried to grow by seeking new clients.
- With insufficient pre-planning of staff numbers and experience, its programmers came under pressure.
- Working too hard, against unachievable deadlines, they simply made mistakes in the code they built.
- This first caused *existing* clients to be annoyed and look for other suppliers,
- … then word got around the industry that this firm was not reliable any more – its reputation resource 'drained away',
- … so management found it increasingly difficult to win new clients.
- [In addition – not shown – the pressure damaged morale, raised staff loss rates, increasing still further the pressure on remaining staff.

It is very common that *current* quality drives immediate loss of existing customers, since those customers experience the problem directly, whereas customer *win-rates* are only affected by reputation (new customers cannot have any direct experience of current problems).



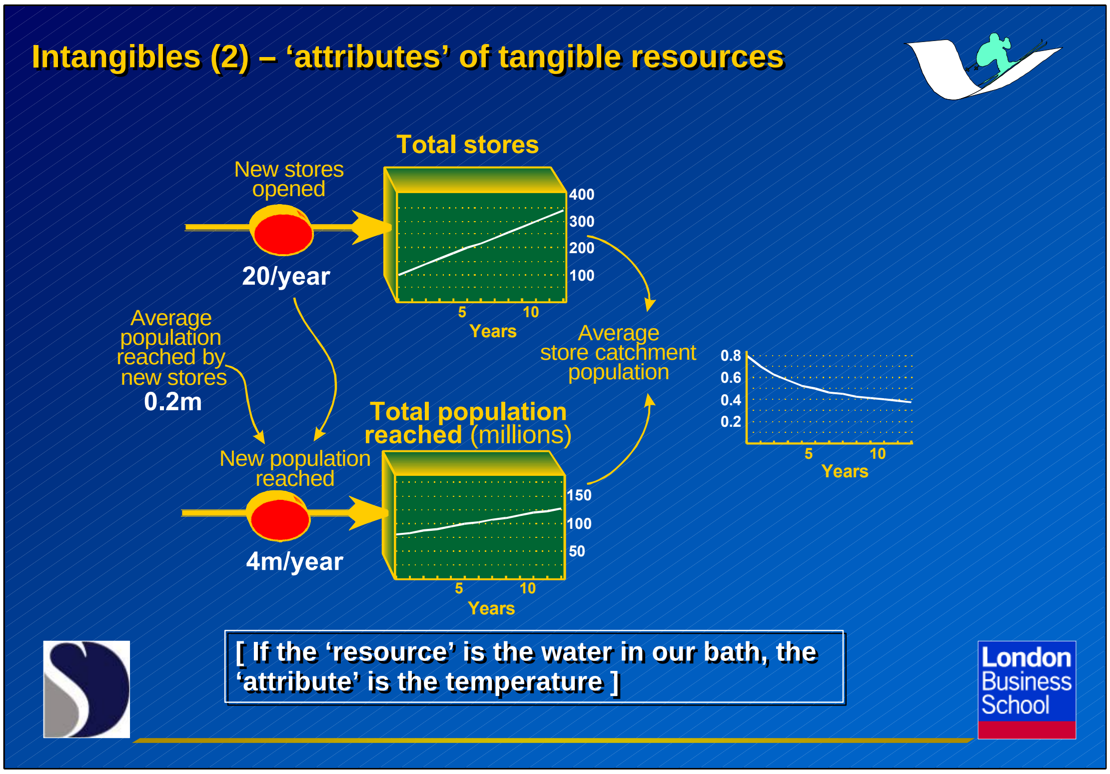
Staff, customers, investors and others are often susceptible to an insidious effect that goes unnoticed until a disaster strikes …

- We all tolerate a certain rate of irritation … late trains, poor meals, errors on bank statements, etc. But we forgive or forget these irritations provided that they are not too frequent or serious.
- We therefore accept a varying but modest level of background annoyance.
- If the errors become more frequent, though, or more serious problems arise, the annoyance 'tank' starts to fill faster than we forgive.
- If this continues, our annoyance hits a limit that we are not prepared to tolerate, and we act – switching to car travel, a different restaurant or a new bank.

By this point the problem is irredeemable, though it could have been prevented by early detection of the increasing annoyance – e.g. by over-compensating for the problems, and making sure they do not recur.

Staff, investors and others may show very similar behaviour:

- Staff react to increasingly frequent changes to what is expected of them, to changed working conditions etc.
- Investors tolerate moderate and infrequent disappointments in a firm's financial results, but react increasingly to larger disappointments.



In very many cases, key tangible resources carry one or more important attributes that determine their contribution to performance, or to other parts of the architecture.

- Charities benefit from richer, more committed donors, as well as from *more* donors.
- Professional firms benefit from brighter, more experienced staff, rather than just more of them.
- … and there may several important attributes - banks prefer to issue bigger loans, at higher interest rates, and at lower risk of default, rather than just more loans.

These relationships are readily captured and quantified, at least to a reasonable approximation, in most cases. And if these attributes make a difference to our performance, we have no choice but to deal with them. If we wish to *improve* a resource (rather than just grow it) we have three options:

- ‘Add hot water’ – hire smarter people, go for bigger clients …
- ‘Selectively remove colder water’ (not actually possible for a real bath!) – close small accounts, discontinue slow-selling products …
- ‘Add a heater’ – help customers build their business, train staff.

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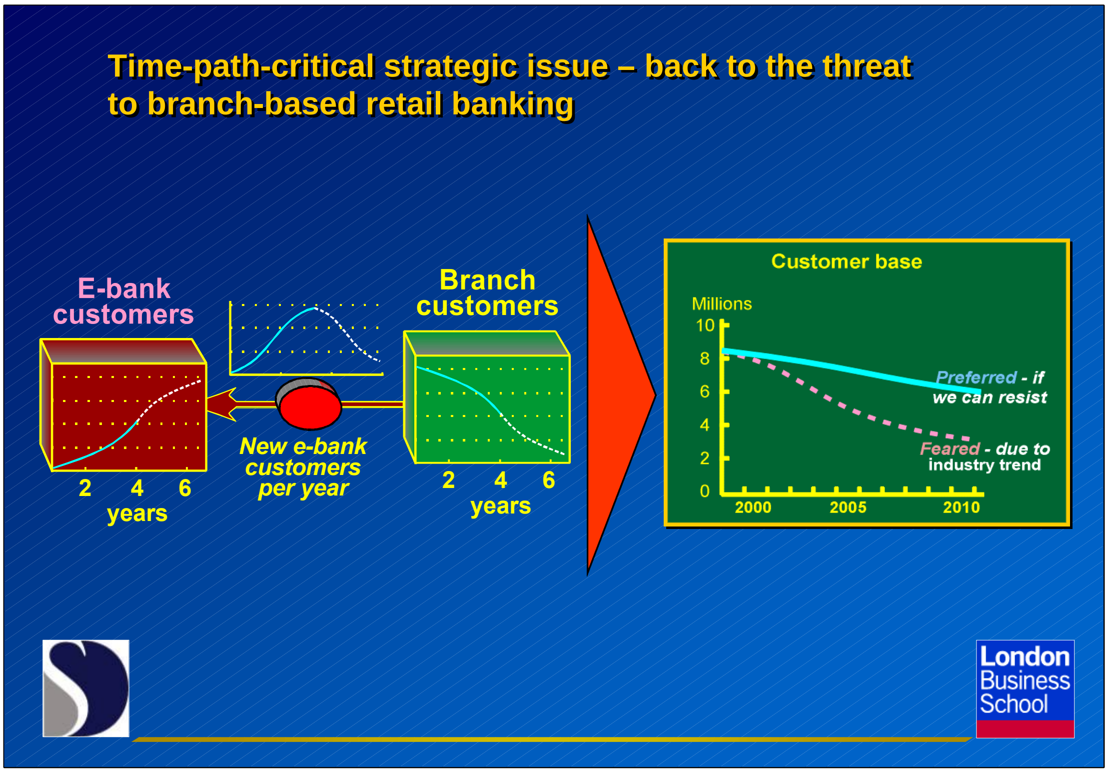
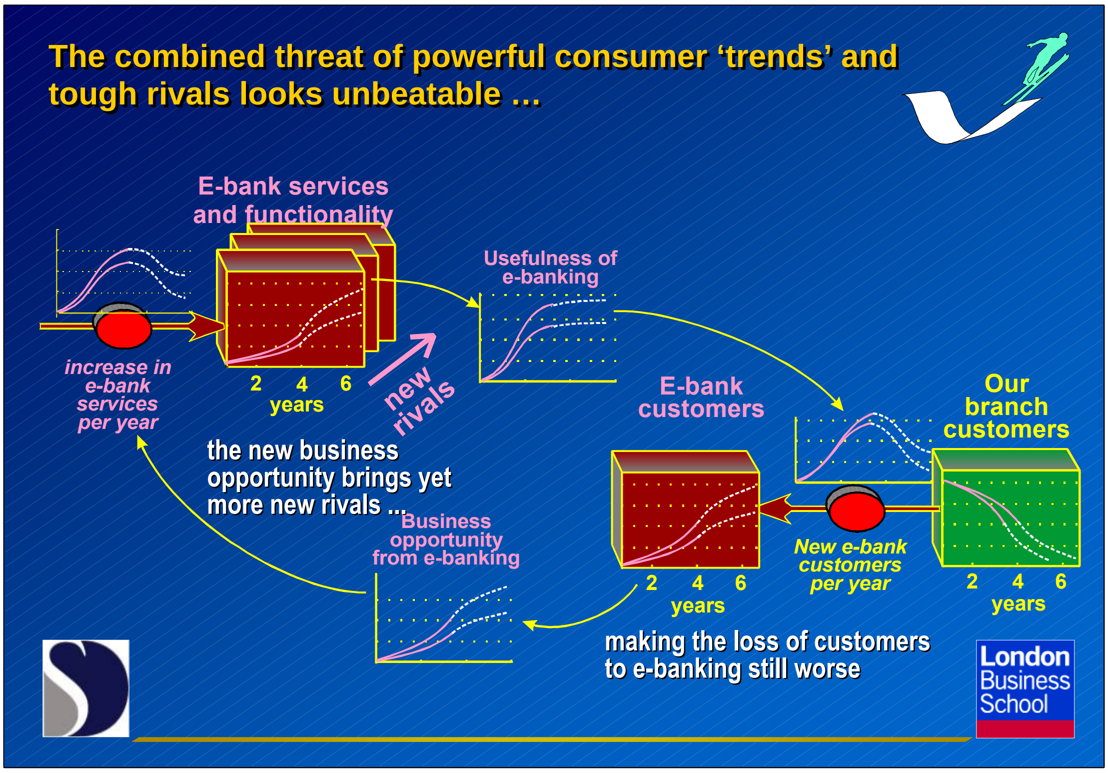


Several of the elements of the Strategy Dynamics approach helped this retail bank, whose challenge from the e-banks was described earlier.

- Performance is threatened by the outflow of customers – at a rate that is already happening as the case starts, but which may accelerate.
- This is a rivalry dynamic (type-2), so the bank has to put in place a system of resources that will counter this outflow.
- Part of the cause for this loss is a significant level of 'annoyance', caused by poor service quality.
- The better quality customers are most at risk – high-net worth individuals, who benefit most from looking after their financial affairs.

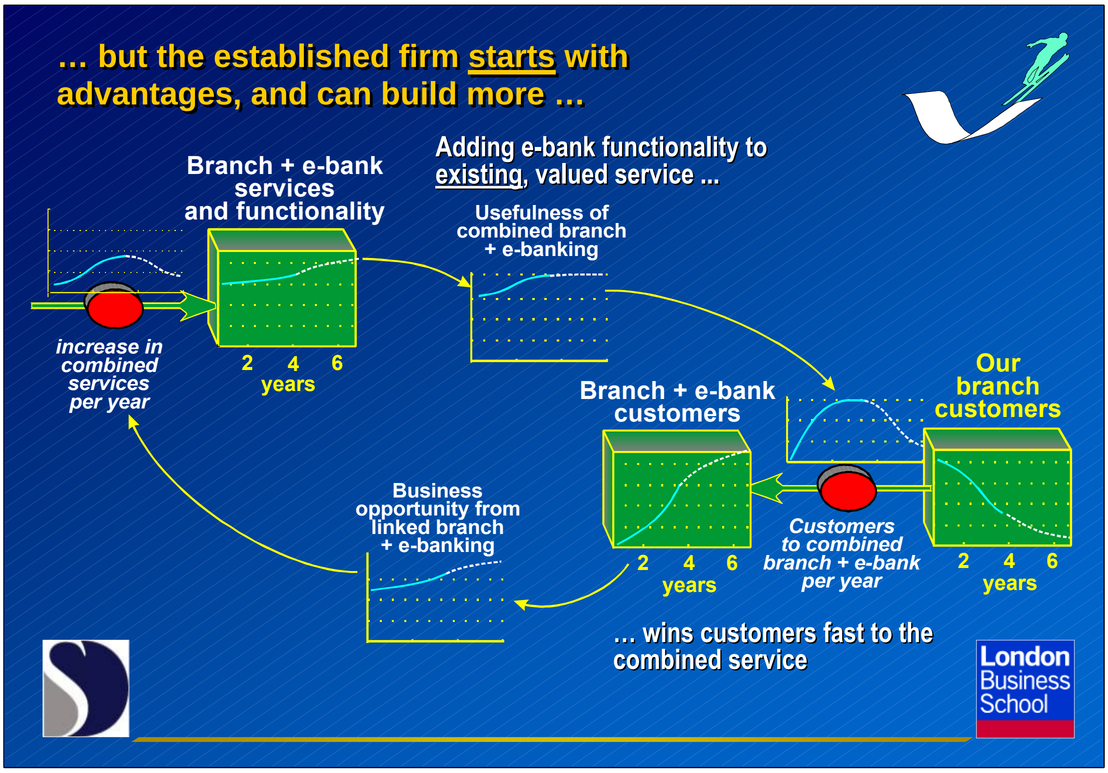


The loss of consumers looks inevitable, because e-banks seem to offer services and value that are much more useful than branch-based services.

Furthermore, the rapid early growth in consumers taking up e-bank services makes the business opportunity appear very attractive. So more new e-banks are started, driving forward the rate at which services are improved, and accelerating our bank's loss of branch customers.

The process is only likely to stop, it seems, when everyone has moved across to the new services, and all scope for further service development ceases.

But this scenario is based on a false assumption …



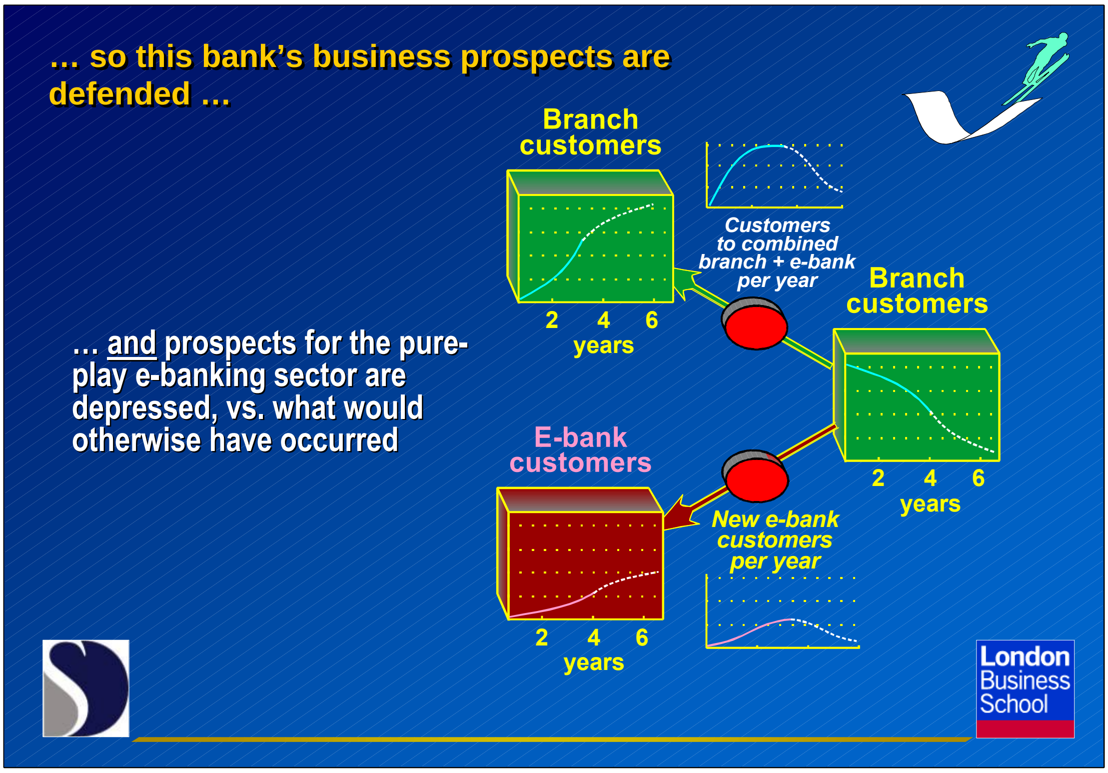
… the false assumption is that existing branch-based services are of very limited value, compared with what e-banking can offer. This is not, in fact, the case. Not only do existing branch networks provide consumers with services that are substantially useful, but the banks that run those networks also have a level of trust in consumers' minds and a resulting brand loyalty.

The established firms, then are starting from a strong position on which they can build. This they can do by designing an e-banking service that is closely integrated with their existing branch network, allowing consumers to choose any of three options:

- stick with the branch-based service,
- switch to the e-bank service, or
- use both branches and e-services interchangeably, to any degree.

The established firms face some challenge in pulling off this strategy, not least of which is their heavy cost-base. But, though they will need to drive those costs down, they are stuck with most of them in any case if they are to continue serving branch customers at all.

The trick is to turn these costly resources to advantage, and leverage the branch network, its staff, its IT infrastructure and, critically, its customer information, to maximise the rate at which customers transfer from 'branch-only' to 'any combination of branch + e-services'.

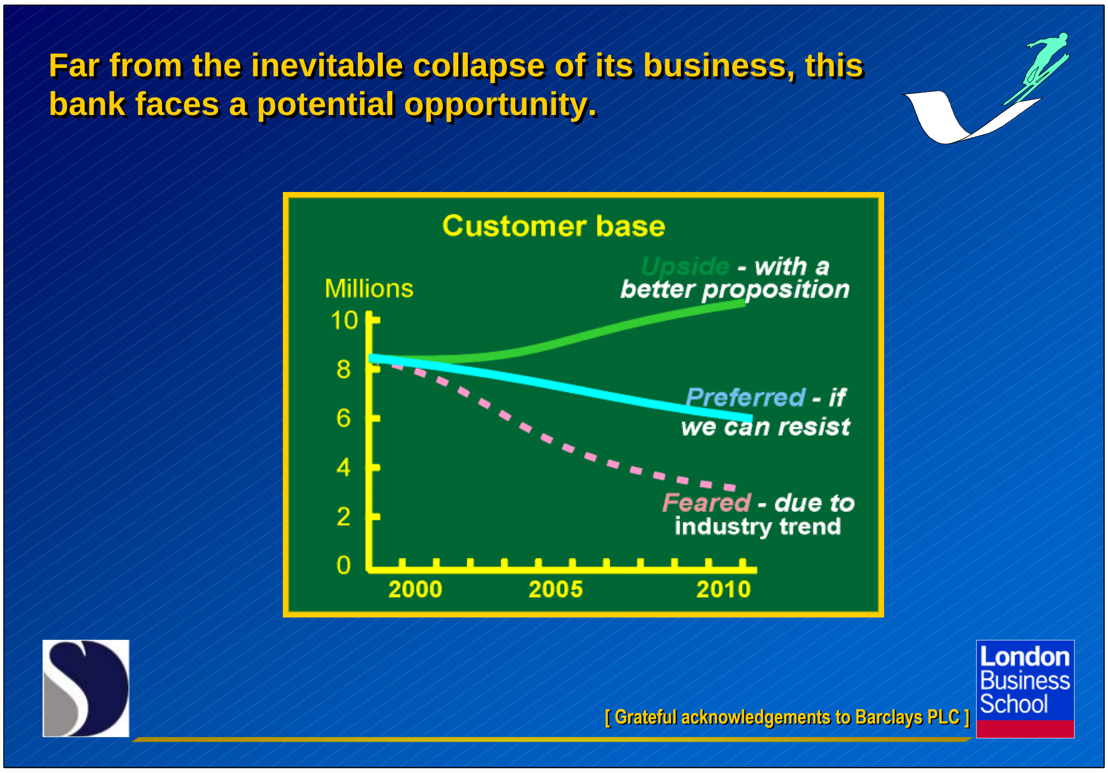


So – the destruction of branch-based banking by e-banks is far from inevitable. The incumbent banks can make the future follow a different path. By creating an integrated set of branch+e-services, they will create a future that would otherwise not have arisen. Moreover, the more such banks respond in this manner, the more will the market in future feature this mix of services, rather than migrating to being dominated by pure e-banking.

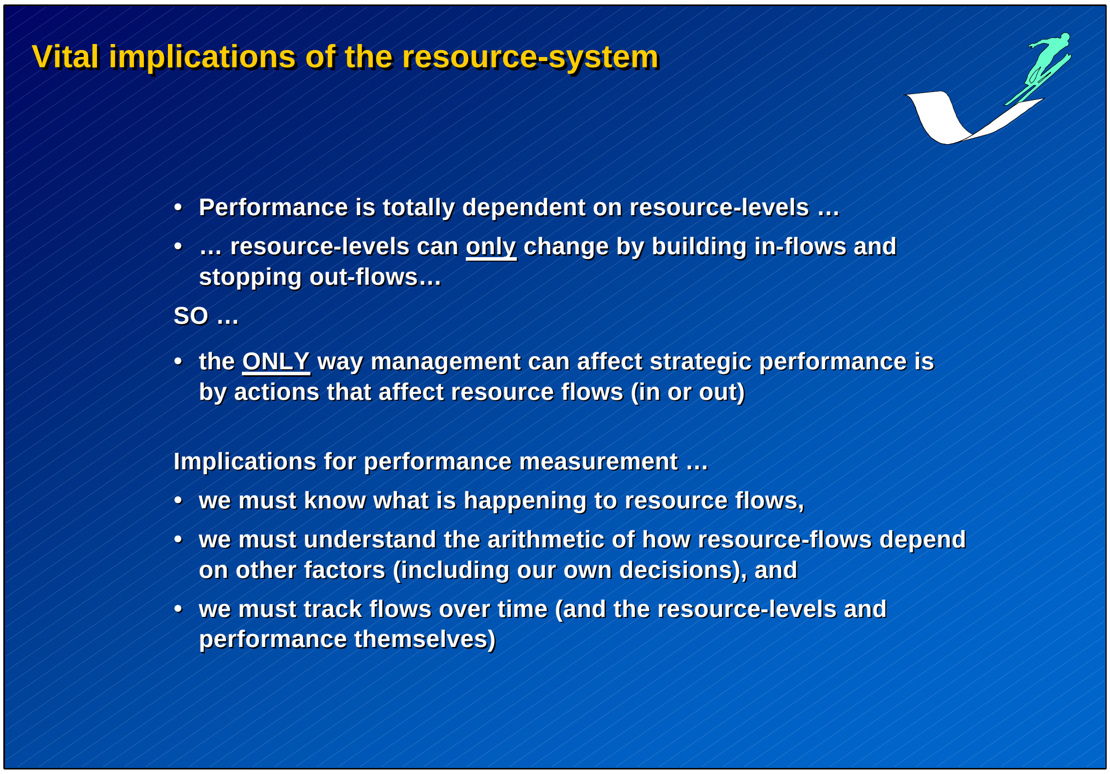
By pursuing this strategy, the incumbent branch networks will also make prospects for the pure-play e-banks considerably less attractive than otherwise. Furthermore, the earlier and more strongly the banks implement this strategy, the more successful they can make it become, not just for each firm alone, but for the entire sector. The reason for this is as follows:

- Entry by new pure-play e-banks is driven strongly by the perception that a major business opportunity exists
- By driving strong development of integrated services, the traditional banks demonstrate to would-be newcomers that this opportunity does not, in fact, exist on any scale.
- With a much-reduced opportunity, newcomers are less inclined to enter.

Unfortunately, in most developed markets, incumbent banks have been slow to respond, encouraging the start-up of many pure-play e-banks. With no brand on which to build, the majority of these operations have to invest hugely in advertising and discounting, destroying not only their own prospects for profitability, but also the profitability of the established banks.



This particular bank, then, is able to ‘buck the trend’, not only on its own account, but also to some degree for the industry at large. Far from being destroyed by the change in the market, brought about by the change in consumers’ behaviour that internet technology makes possible, they open up for themselves the chance of *growth* at the expense of both their slower rivals and failing e-banks.



The Strategy Dynamics approach is tough – it needs:

- data, which is often not available (and most of what *is* available is often not helpful to the basic questions that need addressing),
- discipline – to follow the method accurately
- time – but not as much time as is often spent on approaches that seem simpler, but take teams less far, more slowly.

But evidence is building that the effort is worthwhile – no pain, no gain!

The process is essentially simple, though there is much opportunity to develop it further than these first steps.