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A SYSTEMS APPROACH FOR CHANNEL MANAGEMENT IN FINANCIAL INSTITUTIONS

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June 2000

ABSTRACT

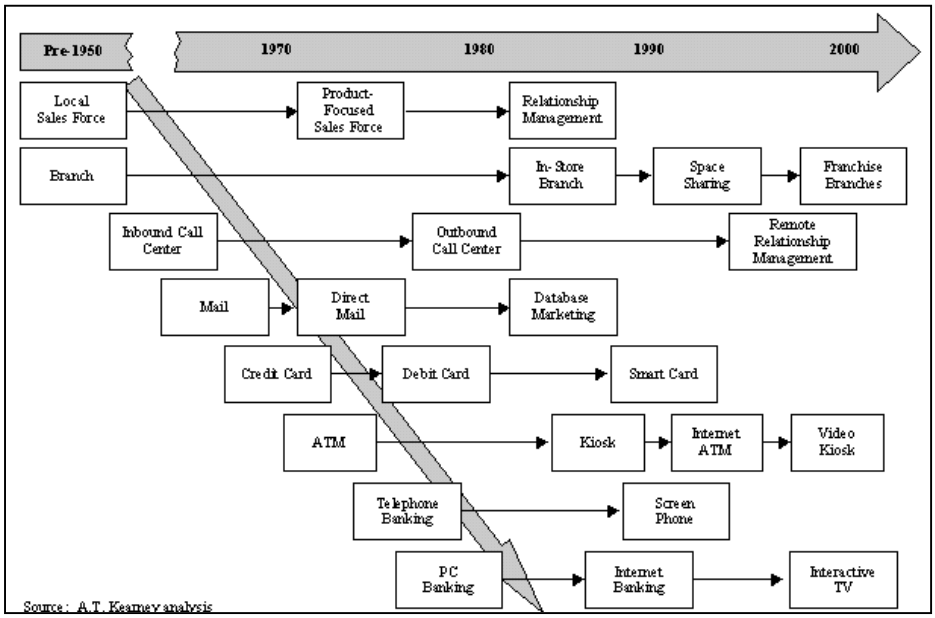
Increasing customer sophistication, broadening competition and changing technologies have significantly impacted retail financial services and the channels through which customers interact with financial institutions. It's not only the number of channels that has increased dramatically, but also the functionality of those channels has expanded significantly.

This paper is based on a recent study completed using System Dynamics methodology to demonstrate the challenge of managing the broadening channel network to achieve the best financial performance in the long term. It first elaborates on the A.T. Kearney approach to channel management in the financial sector – Integrated Channel Management –, which forms the basis of the study. In the second part of the paper, the System Dynamics model and the Flight Simulator will be briefly depicted.

A Disciplined Approach To Channel Management: INTEGRATED CHANNEL MANAGEMENT

Highlightened competition and the increasing sophistication of customers in the sector have forced financial institutions to provide their customers with a greater variety of distribution channels and, more importantly, coordinate the marketing and distribution strategies across all channels.

Figure 1. Evolution of Channels



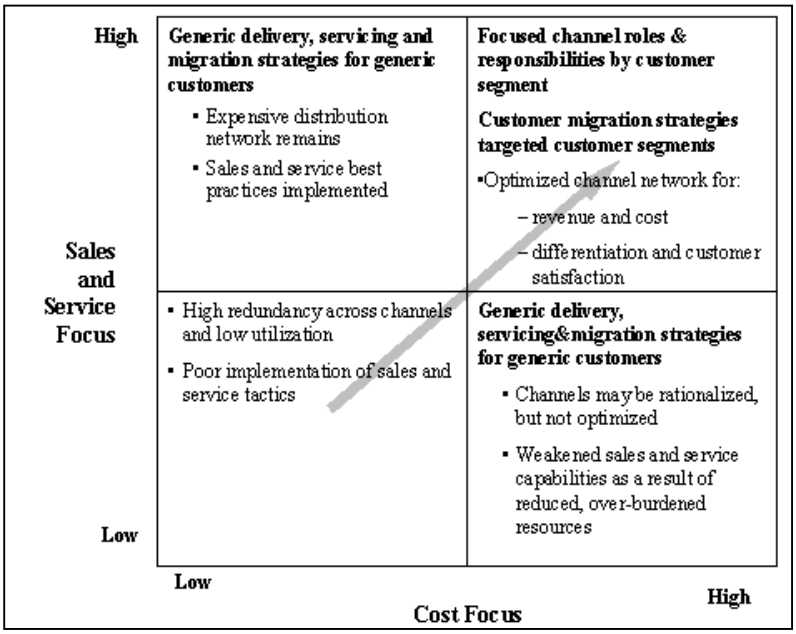
Thanks to recent improvements in technology, retail customers now have the opportunity to benefit from the cost advantages and convenience provided by institutions that have made heavy investments in channel development. However, recent A.T. Kearney research shows that the second part – effective management of the channels – is an important issue, which becomes more challenging with the development and evolution of each channel:

- Channel strategy and planning is not coordinated across all channels with focused roles and responsibilities being assigned to each channel

- Channel economic data, such as activity cost by channel, is not fully analyzed for channel strategy, capacity and investment decisions
- Channel capacity and investment decisions are not made from a cross-channel perspective
- Customer preferences by segment are not considered in determining channel roles, and capacities
- Proactive strategies are not used to migrate customers between channels

Enhanced competition is forcing all financial institutions to improve and optimize the value of their evolving channel networks. Some manage channels to reduce costs, some manage channels to enhance sales, but few if any, succeed at both. A sales and service focus results in untargeted cross-channel marketing and distribution strategies which requires heavy investment, whereas focusing on cost reduction makes it difficult to maintain a competitive service and distribution offering.

Figure 2. Sales&Service vs Cost Focus in Financial Institutions



Optimizing the channel network, however, is not an easy task and demands an integrated approach across all channels. Effective channel integration should start with the development of a channel network plan and an integrated channel strategy. This includes determining which channels will be used to sell or service specific customer segments for specific products or services taking into account *several dynamic and interrelated factors*. Channel network capacity allocations should then be derived from the channel strategy. Some of the benefits of an integrated approach to channel management are:

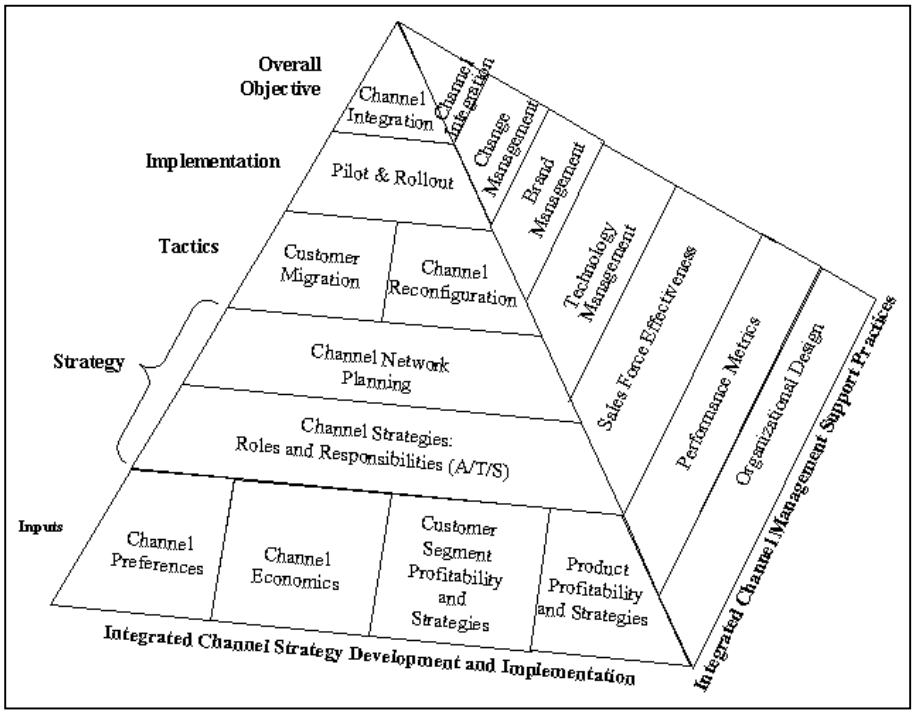
- Reduced channel costs and increased revenues
- Improved customer loyalty, retention and "share of wallet"
- Significant market differentiation and, thus, competitive advantage

Integrated Channel Management is an approach to manage evolving channel networks as an interdependent and integrated portfolio aiming at delivering all the significant benefits stated above by taking into account the myriad of competing, complex and subjective factors related to:

- Customer preferences and needs,
- Customer segment profitability and strategies,
- Product profitability and strategies,
- Channel economics and performance,
- Organizational capabilities and channel competencies

In addition to considering all these factors, developing a cross-channel strategy requires determining which channels are more effective in which of three types of activities that take place between the retail customer and the financial institution:

Figure 3. Integrated Channel Management Framework



Types of Activities

1. Acquisition
   - Information Dissemination
   - Prospecting
   - Sales
   - Cross-sales
2. Transaction
   - Applications Processing
   - Account Activity
3. Service
   - Account Inquiry
   - Account Service
   - Problem Resolution

Once the channel strategy has been defined, customers need to be migrated and the existing channel network needs to be reconfigured. Finally, all the support practices should be in place to lead to successful implementation.

CHANNEL MANAGEMENT MODEL

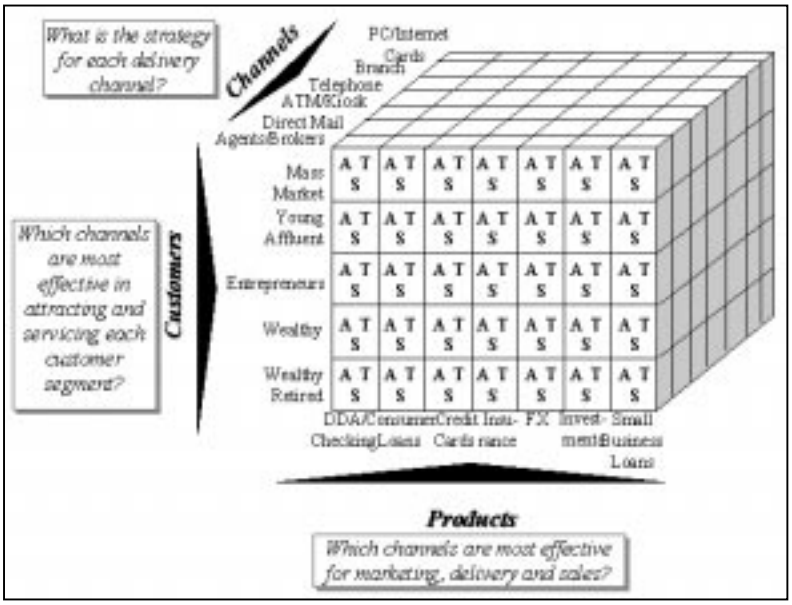
The objective of the study is to develop a *prototype* model for one component of the Integrated Channel Management Framework – Channel Roles and Responsibilities- using a system dynamics approach to:

- Demonstrate and understand the complexity of channel strategy and capacity decisions given the myriad of dynamic and interrelated factors (channel, product and customer related) to be considered

- Prove this complexity by only demonstrating the impact of one variable, - channel capacity decisions on customer satisfaction and bottom line profitability

- Demonstrate the benefits of other approaches, such as customer segmentation, on profitability

Figure 4. Channel Strategy Cube



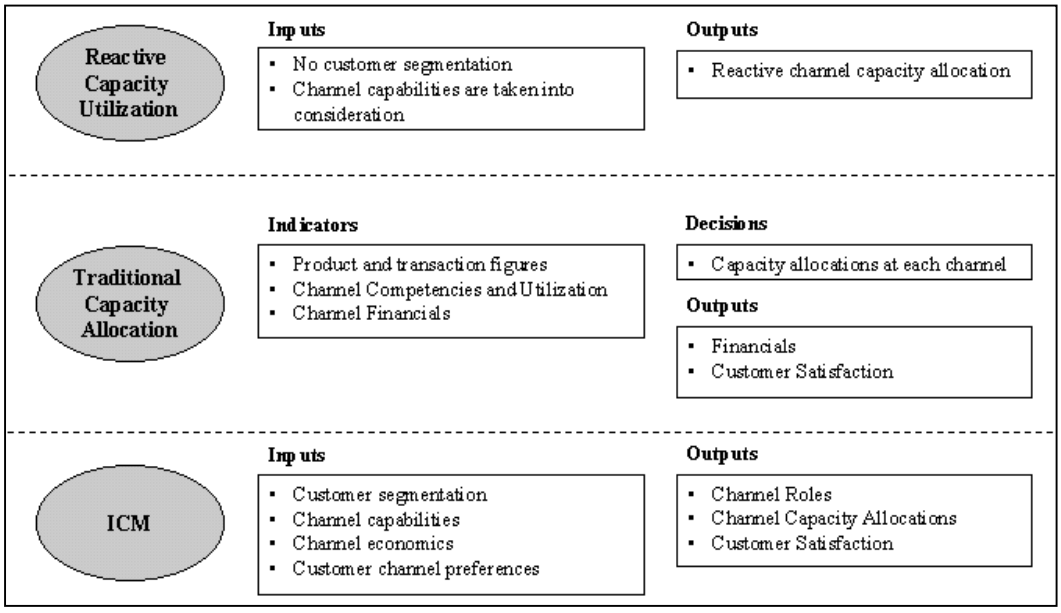
Several assumptions and simplifications have been made for prototype purposes:

- 3 channels with fixed capacities were represented in the model which were chosen based on their different cost structures, competencies and customer preferences
  - Branch
  - ATM
  - Call Centre
- 3 products were selected , based on their different sales and service requirements, channel variations, and customer preferences
  - Investment Products
  - Credit Cards
  - Checking Accounts
- 5 different customer segments were included with different profitability levels, channel preference and sensitivity to channel availability
  - Best Customers
  - Good Customers
  - Marginal Customers
  - High Potential Customers
  - Unprofitable Customers
- Impact of competitive strategies (product features, price, promotions ...), product profitability etc. is not factored into the model for the sake of simplification.

Data estimations were made for one large and one medium-size Turkish bank based on publicly available information (Ex: Yearly revenue, profit, channel capacities, channel activity volumes etc) and published projections.

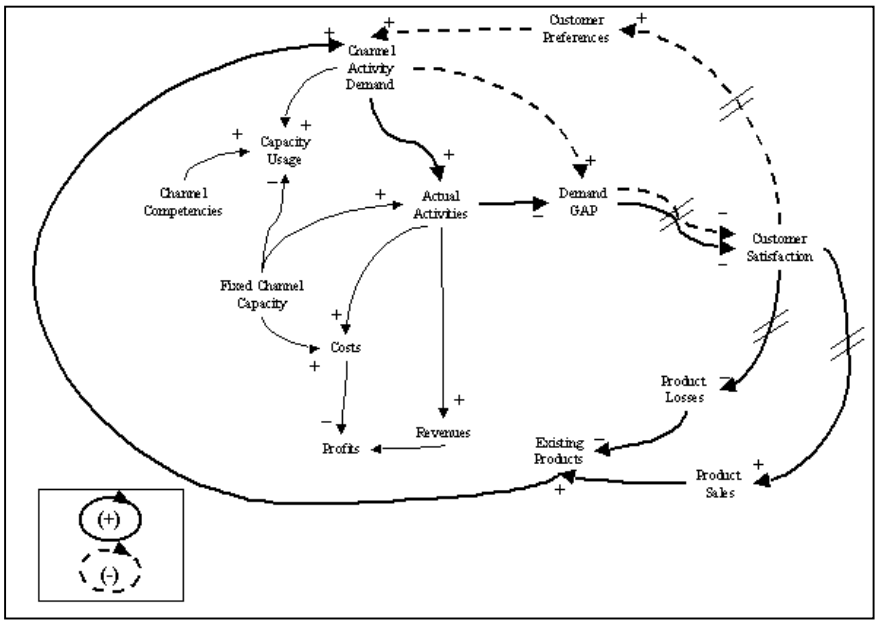
The impact of conscious capacity allocation decisions on customer satisfaction and profitability were analyzed by developing three versions of the model:

Figure 5. Versions of the Model



Version 1: REACTIVE CAPACITY UTILIZATION

Figure 6. Loop Diagram for Reactive Capacity Utilization



This version assumes that there is no intervention by the bank to change customer behavior and impact channel utilization. Thus, channel capacities are utilized reactively based on the customer demand for activities and available capacity at each channel.

Given a fixed capacity with no assigned channel roles, the major determinant of the revenues and costs is the actual number of activities done at each channel for each product, which is constrained by the fixed channel capacity. The result is a pool of 'acquisition, transaction and servicing' demand, which should be satisfied with the total existing capacity of each channel. Thus, revenues and costs (fixed plus variable cost/activity) increase as long as the fixed capacity allows them to do so and the negative loop of customer satisfaction starts dominating after this point.

Version 2: TRADITIONAL CAPACITY ALLOCATION

Some user intervention exists to represent the way today's executives make decisions. In this version, the user can review indicators like total number of products, overall customer satisfaction, number of activities at each channel, financials etc. and is expected to make decisions regarding capacity allocations for Sales and Non-sales activities at each channel.

The same feedback loops work for the number of activities other than the channel capacity allocations. Since the user makes conscious decisions as to what percentage of the channel capacity to allocate to specific type of activities, the channel capacities allocated to different types of activities are dynamic although the sum is still fixed. This way, the user can control the fixed cost associated with three distinct types of activities and their volume at different channels.

Figure 7. Decisions in Version 2

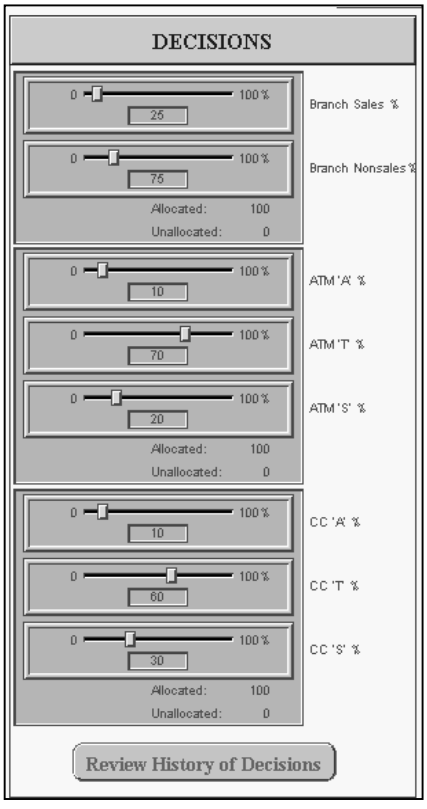


Figure 8. Loop Diagram for Traditional Capacity Allocation

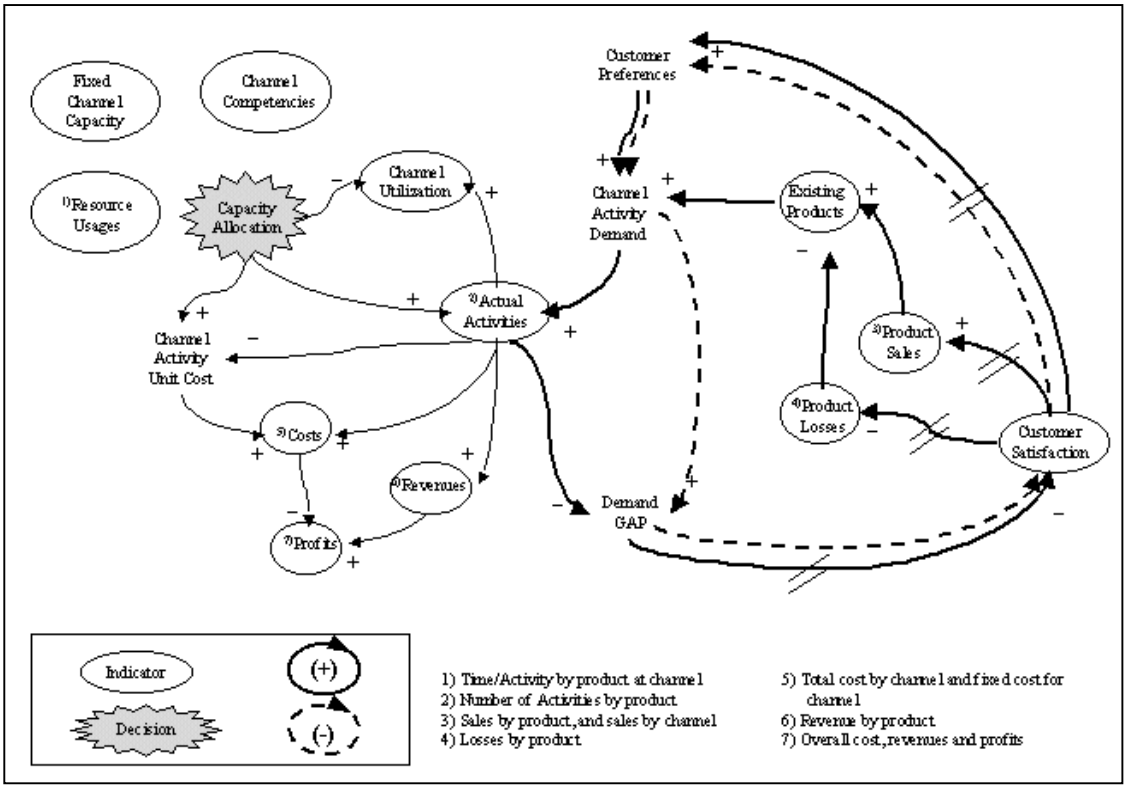
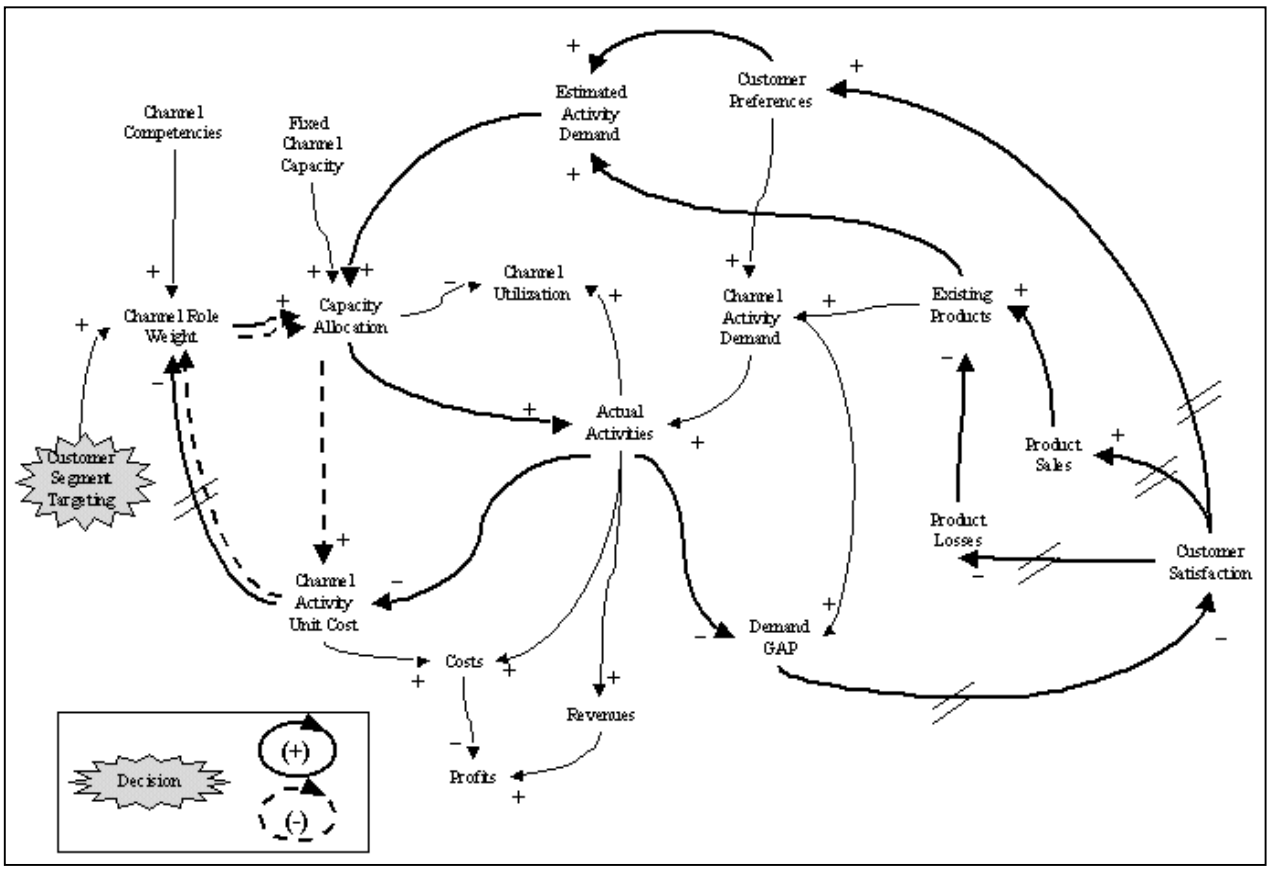


Figure 9. Loop Diagram For Integrated Channel Management



Version 3: INTEGRATED CHANNEL MANAGEMENT

The objective of this version is to demonstrate the complexity of all the factors ICM covers and how this impacts the financial performance, as well as customer satisfaction and channel utilization. The model considers all the factors in the framework and makes an allocation decision on behalf of the user. There is no interaction by the user other than altering such high level strategic variables as segmentation targeting and management sensitivity to customer satisfaction.

The model assigns a "role" to each channel, which defines the relative weights for the three types of activities provided to the five different customer segments for the three different products by considering target segments at each channel, channel competencies and the relative unit activity cost for the different products at each channel. The third component of the channel role definition, - channel unit activity cost- is again a dynamic variable that changes with the capacity allocated to each type of activity at each channel for specific customer segment and product.

Finally, the role assigned to each channel gets weighted again with the estimated activity demand at each channel, which then gives a percentage of channel capacity to be allocated to the three types of activities for each product and customer segment.

RESULTS FROM INITIAL RUNS

The first runs of the model demonstrated some useful insights regarding financial performance and customer satisfaction, which are the key important performance metrics to balance when managing channels

In the absence of a structured approach to channel strategy, number of products boost initially, assuming more than enough channel capacity to serve our customers. This results in increasing revenues and increasing costs. Since fixed costs are not managed to get the biggest revenue by utilizing the channels in the most effective way, the ultimate goal, profits, is not very satisfactory. On the other hand, since all demand from all the customers is satisfied, good customer satisfaction has been achieved initially. However in the long term, the uncontrolled increase in the number of products has resulted in a scarcity of channel capacity and, thus, decreasing customer satisfaction. This, in turn, has had its major impact on our sensitive profitable customers.

It has been observed that users can make clever decisions if they are given some high level indicators as in the second version. In the absence of customer segments and unit activity costs by product and channel, it proves difficult to allocate channel capacities to different activities. In addition, the lack of a mechanism to assign capacity to specific products makes it difficult to control the service provided for different products which have their own cost and revenue structure. Making these simple allocation decisions proves very difficult even for 3 channels and 3 products with the limited number of indicators. Overall, the financial performance has been considered as satisfactory, whereas customer satisfaction suffers in most cases.

The last version has been found quite useful in determining the impact of different segmentation decisions on a variety of performance measures. As the allocation decisions, in a way, force customers to migrate to channels other than the ones they'd prefer, customer satisfaction has suffered during some runs, depending on the management sensitivity to this factor. Financial performance has tended to exceed the satisfactory levels, even with relatively low levels of number of products and loss of customers, which were not targeted.

On the other hand, even reading the allocation decisions done by the model has been difficult. Trying to trace the decisions back to the logic made the users lose the overall picture.

CONCLUSION

Effective Channel Management requires defining a cross-channel strategy considering a number of complex, dynamic factors regarding customers and products. This nature of the problem makes it suitable for adopting a System Dynamics approach to help today's financial executives in making clever decisions.

This study helped A.T. Kearney consultants to develop a good understanding of the dynamics involved in channel management. There are still opportunities to improve the model by integrating new dynamics related to capacity increase decisions, competition factors, etc., however the large number of channels and products makes it impractical to do so.

Finally, the model has proved to be an effective way of communicating the Integrated Channel Management concept and, more importantly, understanding the dynamics behind it, which will aid today's executives in making their decisions about one of the most important components of Integrated Channel Management, -Channel Strategy- which is the starting point for a really integrated channel network.