Franchising in Commercial Banking

by

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Submitted to the Sloan School of Management
in Partial Fulfillment of the Requirement for the Degree of

Master of Science in Management

at the

Massachusetts Institute of Technology

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ABSTRACT

In the increasingly competitive environment faced by commercial banks at the retail segment of the market, one of the greatest challenges is to build and maintain an efficient and effective distribution channel, offering a superior quality of services to the customers, with low operational costs and minimum initial investment. Although apparently paradoxical, all these factors are crucial for a bank in getting and sustaining competitive advantage on such a highly competitive market.

The focal point of this thesis is the proposition of the franchise system for the network of branches at commercial banks, as a way to dramatically reduce the constraints faced when trying to improve the distribution channel and, as an ultimate consequence, becoming more competitive.

I firstly set the backdrop for the thesis in analyzing the importance of the distribution channel on the competitiveness of a commercial bank operating on the retail segment. The conclusion of this analysis is that the traditional model of growth using owned branches and ATM’s has two main drawbacks. The first is the lack of flexibility in fitting the channels to the demand. The second is that it does not address the main constraints of growth: free capital to invest in growth and human resources with the desirable profile.

With the backdrop set, I propose a set of alternative models of growth that are intended to increase flexibility (and eventually efficiency) of the distribution channels, and mainly to reduce the influence of the constraints on the growth and efficiency. Among these alternative model it is the franchise system.

Most of the thesis is devoted to the description of the franchise model for commercial banks, with the relevant operational aspects of the interfaces between the bank and the franchisees, as well as the importance of the design of the incentives in order to fully achieve the potential benefits of the system. Complementing the description of the potential benefits and the risks in adopting the new system, I establish a set of actions to reduce those risks as well as the basic requirements a bank must meet before initiating the process of implementing the franchise system.

Thesis Supervisor: Henry Birdseye Weil
Senior Lecturer of Management
Acknowledgements:

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I want also to thank Banco Itaú for the sponsorship that permitted my pursuing of the master degree at MIT. I want specially to thank my former boss at Banco Itaú, Mr. Olavo Bueno, who unfortunately passed away recently, for his support and encouragement in developing my ideas, even when they seemed "too heterodox" for the standards in management.

Finally, I would like to thank my wife, Madalena, for her psychological support during the difficult moments, and mainly for her help in listening to my ideas and questioning them, a process that was crucial to the improvement of the consistency of this work.
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1. Distribution Channel as Competitive Advantage

One of the greatest challenges in the retail segment of commercial banking is to build and maintain an extensive network of branches, while offering a superior quality of services to the customers, with low operational costs and small initial investment to build the branches. Although apparently paradoxical, all these factors are crucial for a bank in getting and sustaining competitive advantage on such a highly competitive market. Most banks on the retail segment give up the local responsiveness and closer relationship with the clients in offering highly standardized (and lower cost) products and services, mostly aimed to the lower and medium income segment of market. With this strategy the large commercial banks leave open the doors of the medium/high income segment – the most profitable one - to the banks of relationship or financial boutiques.

My proposition is that commercial banks can (and should) broaden their distribution channel in order to be competitive on the higher segments of the market, while using the huge competitive advantage represented by their size and consequent economies of scale. The banks of relationship are already broadening their distribution channels, but on the opposite direction: many of the small banks are trying to capture part of the mass segment using the Internet as an alternative distribution channel. Some could argue that the fraction captured by these small banks is too tiny to be worthwhile worrying about, but this movement is the beginning of an important change on the commercial banking industry, with a new competitive environment in which new players and competitive factors will be present.

Going beyond the diversification of the distribution channel, banks could also benefit enormously from franchising some (or most) of their branches, a system that has been largely and successfully used on the service industry. The entrepreneurial nature of the franchisees would foster the so needed local responsiveness on the network of branches, allowing the banks to be competitive not only on the low-cost /low-margin segments of market, but also the more profitable segment of the higher income people. Moreover,
some of the basic factors of the competitive advantage mentioned above such as low initial investment, low costs, extensive network would still be possible with the use of the franchising strategy.

The goal of this document is to propose solutions to address the challenges faced by commercial banks in building and keeping competitiveness in a segment of market that demands seemingly contradictory characteristics such as local responsiveness and economies of scale. With this main goal in mind, two main topics will be discussed on this document:

⇒ The proposition of alternative models of distribution channel for the retail segment of commercial banking, going toward the diversification required to be competitive in more than one segment of market. This diversification will result in a greater flexibility to adapt the distribution channel to the aimed segment of market, a characteristic that will certainly have a big impact on the competitive positioning of the bank.

⇒ The establishment of a new business model for management of branches in commercial banking through the franchising system, analyzing the viability of this model given the necessary operational changes, benefits, and risks involved.

The importance of a large and efficient distribution channel for banks

The current buzzword in corporate strategy for commercial banking is “the larger the better”, and indeed, some strategists go beyond and say that only the giants will survive. But while size really matters, we ought to consider other aspects of the banking activity such as efficiency on the use of the available resources, market positioning (competitiveness on diverse segments), and focus on the core business. On this section I will investigate the essence of the influence of a large and efficient distribution channel
on the bank’s competitiveness in order to establish the basis over which my propositions will be evaluated.

The basic business model at commercial banks

Before analyzing the role of the size on the bank’s competitiveness, I will introduce a simple (but quite universal) model that synthesizes the general business model for banks. On the diagram 1.1 we can see that a typical bank can be described by three main lines of business:

<table>
<thead>
<tr>
<th>Infrastructure and Support Functions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Money Dealer</td>
</tr>
<tr>
<td>Proprietary Portfolio Management</td>
</tr>
<tr>
<td>Service Provider</td>
</tr>
</tbody>
</table>

Diagram 1.1 – The basic business model for banks
Bank as a Money Dealer

This is the most traditional part of the banking business. It involves giving loans to persons, companies or other financial institutions, and getting funds from the same personages.

Cost drivers:

⇒ **Interest and FX rates** paid by the bank, which are influenced by systemic factors (macroeconomics, liquidity, etc), and individual factors such as market power and bank's credit rating.

⇒ **Credit losses** on the loans, which are influenced primarily by the quality of the credit analysis performed by the bank. There is also some systemic influence due to the increase or decrease on the general level of default in the credit market.

⇒ **Operational costs** of buying and selling money, per unit of money bought/sold. These costs include expenditures with marketing, sales, credit analysis and general control.

Margin drivers:

⇒ **Bargain power** - As it happens with any dealer, the difference between the prices paid and received for the product is crucial on the margins. For a retail bank, much of the volume is dealt with many small clients, whose individual bargain power relatively to the bank’s is almost null, and so, banks are often able to get high margins when dealing with individuals. On the other side of the spectrum, at the financial market, the size of the bank is determinant of the prices bid and offered. Large banks can get much better rates than the smaller ones can get.

⇒ **Total volume of deals** – High volumes dilute the fixed costs involved in dealing with money. Specially in retail banks, with their huge structures, the volume of deals is crucial.
Bank as a Service Provider

At the beginning of the banking history, besides the money dealing, the only service available at a bank was keeping safe the wealth. Nowadays it is hard to name all the services provided by a bank to its customers. It goes from bill payments to Merger and Acquisition services, passing by portfolio management, financial advice, credit card and even Internet providing. It is far the fastest growing segment on retail bank.

Another important aspect on providing services is that the banks not necessarily have to “produce” all the services to satisfy the customer needs, differently from the other segments of the bank, which are highly vertical integrated. There may be some cases in which the bank acts just as an intermediary between the service provider and the final consumer. The reasons to act merely as a service broker range from the lack of strategic interest in producing the service internally, to the lack of competence in originating competitively some services at the bank. Some examples of financial services in that banks are just intermediates are credit card issuing and mutual funds management. On the non-financial services, we can see banks selling life insurance and brokerage services. With this non vertical-integrated alternative, banks can offer a much more complete range of products and services to their customers, without having to keep a huge structure to “produce” everything in-house.

Cost drivers:

 reallocating Personnel directly involved in producing and/or selling the services, such as tellers, portfolio managers and investment bankers.

 reallocating Technology used on providing the services, which includes not only IT (equipment and software) but also financial models, procedures, and others.

 reallocating Operational costs, which goes from expenditures with marketing and sales, to general control.
Margin drivers:

- **Value added to the client** – This is how the client objectively evaluates the quality of the service offered. There are some “hard” measures to compare the value added such as number of branches available to collect bills, availability of different kinds of channels (branch, ATM, Internet, phone), or profitability of the portfolio managed by the bank.

- **Perceived quality of the service** – this is the “soft” part of the quality in the sense that it is how the customers’ perception is affected by factors such as helpfulness of the staff, environment of the channel (branch, website, ATM), or size of the line in front of the teller.

*Proprietary Portfolio Management*

This is the part of the banking business in which the customers take the less important role. Here the banks look for opportunities to profit from fluctuations of the market prices (interest rates, FX, stock markets, etc). Obviously, together with the opportunities of gains come the risks of losing money.

Restrictions:

- **Size of the positions** taken by the bank is limited by the size of the its capital. As the profit with proprietary portfolio management is limited by the size of the positions (risk-reward relationship), the potential profits with this activity is restricted by the size of the capital of the bank.

- **Credit rating** is affected by the leverage of the bank’s portfolio. A high exposure to financial risks may affect negatively the costs of the money for the bank.
Growth as competitive advantage

Considering the business model defined above, it is easy to understand why the retail banks fight so fiercely to grow as fast as possible in both directions (capital and geographic extension). With the necessity to invest heavily in marketing to attract more and more clients, and in technology to improve quality and reliability of services, a commercial bank can compete (and survive, indeed) only with scale enough to keep the machines working with a high utilization rate. But this is not the only reason why size matters. Among others, the advantages resulted from the size of the bank are related to:

- **Economies of Scale** – given a fixed amount of investment in technology and infrastructure, the per-unit operational cost decrease almost proportionally with the growth of the volume of transactions at the bank. Moreover, considering that the retail banks generally operate with excess of capacity, the increase on the volume of transactions becomes even more important because the marginal operational cost is nearly zero.

- **Bargain Power** – big players (large capital and volumes) are more likely to get more favorable prices/rates on the negotiations with the “suppliers”: the financial market (for money supply) and other suppliers (material, technology).

- **Market Power** – the size of the distribution channel per se is an important weapon when fighting for market share. The increased perceived quality due to the better availability of services attracts more clients (see below), reinforcing the virtuous cycle of growth. In addition, with the improvement on the quality (objective and perceived), a higher premium can be charged for the services provided.

- **Brand Building** – the perceived reliability of a bank at the market is almost proportional to its size and growth rate. This is related to the common subliminal belief: a bank that is large and/or growing must be solid (after all, I can see those
solid brand new buildings!), and so, that’s where I will put my money. In this case the distribution channel works as a natural publicity for the bank.

**The contribution of a large and effective distribution channel to the growth**

As we saw, for a commercial bank focused on the retail segment, size is one of the main factors of competitive advantage. Before establishing any strategy to modify and/or augment the distribution channel at a bank, it is crucial to understand the real contribution of a better and larger distribution channel to the growth of a bank. It’s possible to summarize the benefits of an effective and large distribution channel in two dimensions:

1. **More volume of transactions due to the higher capacity and effectiveness of the distribution channel.**

   To make this idea more understandable, I will use the metaphor of a bank being a reservoir of money and services. It doesn’t matter the size of this reservoir if the pipe that takes resource to and from it is the bottleneck of the system.

   The banks competing on the retail segment are not generally the most leveraged banks in the financial market, and so, there’s plenty of room on their “reservoir” to work with. Hence, in this segment of banking, the “system of pipes” generally is the bottleneck, either because of the insufficient extension of the network of branches (size) or because of the inadequacy of the channel with the recipients of the resource (effectiveness). The capacity is related to the “caliber” and number of pipes available on the system. A larger distribution channel certainly will be able to carry a larger amount of resources than a smaller system (keeping all the other variables constant), resulting in a higher volume of transactions. On the other hand, increasing capacity is not effective if the pipes are leading the resources to the dump area instead of taking to the right receivers (matching the channel with the demand). It is important to
organize the system in order to take the resources to the right recipients, using as little energy as possible (minimum cost for the same result). To do so, it is essential to have available as many different kinds of pipes as possible, in terms of capacity and quality, permitting the proper matching of the pipe (channel) to the recipient (segment of market). That's why diversity of distribution channel is as important as its size.

2. Better services to the clients through the increase of the availability of services – being everywhere, all the time, with a low cost.

Here the benefit of having an effective and large distribution channel is more related to the ability of attracting and retaining clients than to the capacity of carrying resources. An important factor of quality at commercial banks is the availability of services, both in extension and temporal terms. The services offered by a bank with an efficient and large distribution channel (network of branches, ATM and Internet services) are much more attractive due to their availability than to their intrinsic quality. Hence, considering the value added by the distribution channel to the products and services offered by a bank, it is also an important tool to attract clients, becoming an important factor on the competitiveness of a bank.
The traditional model of growth

The traditional strategy to grow is to increase the capacity of the distribution channel, adding as many branches to the network as the bank’s capital permits. Or more recently, putting the bank’s service on the Internet. The reasoning on this strategy is that simply expanding the distribution channels will automatically result in an increase of the capacity of the system as whole, proportionally to the capital invested on the expansion. On this model, the expansion is based on one of the following methods:

- **Building new full branches green field** – in a kind of war for conquering new and unexplored territories, commercial banks traditionally expanded aggressively their networks of branches in building thousands of new branches. With the saturation of the best sites, and the tightening of the competition (and the consequent pressure to cut costs and increase return on investments), this method has become less relevant than it was in the past.

- **Buying existent branches or whole banks through M&A deals** – this is the current preferred method of growth. The recent mega-deals (merger or acquisition) are a clear evidence of this new preference. Its advantage over the previous method is that in buying branches or whole banks, a bank is also acquiring market share, which may be less expensive and more effective than developing new markets with new branches, and “stealing” market share from your neighbors.

- **Installing ATM’s** – even though this is a less expensive method of growth, it should not be compared to the previous ones because it doesn’t cover all products offered by a bank.

- **Banking through the Internet** – more than an aggressive tool to expand business, for the commercial banks the use of Internet is still quite defensive. As it was mentioned previously, with the Internet, small banks can offer their products to a larger segment of market, starting a silent invasion onto a previously captive territory
for the large commercial banks. There was no other alternative for the large banks but go to the Internet too.

The challenges with the traditional models of growth

Capital Constraint

On the traditional models of growth, a bank invests its own capital on building new branches, setting-up the necessary infrastructure and staff. This process is highly demanding both in terms of capital necessary to start-up the structure, and in terms of managerial and/or operational skills needed when building the network of branches (Real Estate, Human Resource, Logistic, and Basic Technology – telecommunication, hardware, furniture, etc).

We saw on the Business Model section that money is the rough material for banks to operate as a money dealer, in which money is the product bought and sold by the banks. Not to mention that capital is also one of the inputs at the Proprietary Portfolio Management function, when buying assets to form the portfolio. As highly leveraged firms, banks need to optimize the use of the capital available, or in other words, they must “squeeze” as much as possible the capital available in order to get the maximum return per dollar on capital invested.

Considering that real estate is traditionally regarded as a very low return (and low risk) investment, besides not being part of the bank’s core business, using (or wasting!) the precious capital available on building branches instead of leveraging the bank business does not seem to be a very savvy. However, we saw that growth is vital for the retail banks, and so, the network of branches must be built. This paradox of having to grow the network of branches while preserving capital to leverage the business is yet to be solved on the traditional model of growth.
Effectiveness of Distribution Channel

We could define the effectiveness of a distribution channel as the group of the following characteristics:

✓ Being accessible to the target clients.
✓ Providing all the services demanded by the customers.
✓ Providing feedback to the firm.

On the traditional model, some channels used are not totally accessible to all customers. An important example happens on the Internet banking: due to necessity of specific equipment to access Internet (computer, modem or telephone), some (or many) customers cannot use this channel. Another case is the use of ATM by illiterates or technology-averse people: the equipment is physically available but not accessible to this set of clients due to personal limitations or preferences.

Another factor of ineffectiveness of the distribution is that some channels do not deliver all the set of products and services provide by the bank. For instance, a client cannot get a loan through an ATM machine, or get cash at the bank’s website. Or a more basic problem, the service may be geographically too far from the client.

Finally, there is the issue of the channel providing feedback to the bank. On the electronic channels (ATM, Internet), the process of capturing feedback is quite passive, overly dependent on the customer willingness to provide complains, suggest or demand. On the bricks & mortar channel (branches), it is hard to align the incentives of the agents at the channel (staff) with the needs of the marketing decisions center in terms of feedback. There is no strong motivation for a branch manager to actively supply the marketing department with information about demands, complaints, or new ideas to improve the bank’s products and services. They are not just paid to do so! In addition to the lack of entrepreneurial culture, there is the geographic distance contributing with the problem. It’s very hard to push a large number of dispersed people to act actively.
Economical challenges

One of the issues here is to fit the “caliber of pipe” to the expected flow through it, in order not to waste resources on an oversized structure. There are places where a full branch may not be economically viable, but on the traditional model this is the only alternative to distribute the whole set of products and services. An ATM may not be enough because of its deficiency in supplying all the products.

Another important issue is related to the necessity of getting economies of scale. The traditional way of doing so is to focus the efforts on one segment of market, preferably the largest one. The problem with this strategy is that the margins on that segment are often the lowest. The ultimate goal of all the bankers on commercial banking is to reach different segments of market (mainly the most profitable ones), using the same basic platform in order to get economies of scale. That’s exactly what Volkswagen is trying to do with Passat, Audi, Beetle and Golf. All these models use the same basic platform but each of them is directed to a different segment of market, and so, Volkswagen is able to capture most of the price reservation in each segment.

Strategic and Cultural Challenges

A retail bank must be large enough to get the benefits of the size, but must also develop a high level of local responsiveness to compete with small local banks. These two characteristics are diametrically contradictory, and very hard to develop on the traditional model. In a large mass of disperse employees, working far from the decision center, it’s hard to disseminate the entrepreneurial culture that would be necessary to develop the local responsiveness. This is definitely the greatest challenge in managing large corporations: shaping culture and aligning employees’ incentives to the firm’s goals.
2. Alternative Models of Growth

The alternative models of growth described in this section come to complement the traditional structure in response to the challenges faced by the banks with the urgency on growing fast to be competitive on the commercial banking industry. None of the alternative models is intended to individually solve all the problems. In fact, the greatest strength on the proposition of the alternative models is related to higher diversification provided by the broader set of alternatives available to project and implement the distribution channels in banking.

However, this higher diversification comes associated with the new challenge of coordinating all the different channels in order to extract most of the potential in each alternative, while avoiding problems such as competition and cannibalization. At the end of this chapter we have a discussion of this problem as well as some possible actions toward its solution.

The Lean Branch

Description:

The lean model is an intermediate arrangement positioned between a standard ATM kiosk and a full branch. It consists of a small space containing ATM machines, a point of access to the Internet, and one employee who will be responsible basically for:

✓ Giving support to the clients with difficulties in using the equipment.
✓ Providing services not offered electronically such as loan requisition and concession, investments not offered through Internet, and basic financial advice.
✓ Developing local market through public relations with the community, opening new accounts, and actively selling products and services.
✓ Being the active link between the local clients and the bank, mainly responding to local necessities and providing the bank with feedback from the customers.
On this model, only the functions that involve the direct participation of the customers (front-office functions) would be performed at the branch. All the back-office functions (clearing documentation, check-emission, etc) would be performed at a nearby full branch.

The physical installation of the lean branch may be associated with other non-related activity in order to use the existent infrastructure (building, telephone and electricity links, and parking lot). For example, some of the best candidates for locations of lean branches are gas stations and supermarkets.

**Target Segment of Market:**

⇒ **Small communities** where a full branch is not economically viable, but where only an ATM kiosk is not enough to supply all the services and products demanded for this set of customers.

⇒ **Low-tech or technology averse** segment of customers, who avoid the use of ATM or e-bank either because they don’t want to interact with machines to get the services, or just don’t know how to operate the equipment.

**Limitations and possible answers:**

<table>
<thead>
<tr>
<th>Limitation</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>It is hard to motivate the employee due to the low volumes at the branch.</td>
<td>✓ Use this position as a career launching ramp for account managers.</td>
</tr>
<tr>
<td></td>
<td>✓ Franchise the branch.</td>
</tr>
<tr>
<td>It is hard to control one employee working alone in terms of corruption.</td>
<td>✓ Use technology to control transactions.</td>
</tr>
<tr>
<td></td>
<td>✓ Benchmark the branch’s performance with others’.</td>
</tr>
</tbody>
</table>
**Good because:**

- This solution demands a much lower initial investment (capital) than a full-branch due to the simpler and smaller infrastructure needed.

- The “caliber of the pipe” matches the size of the “recipient”, and so, the use of resources (investments, operational costs) is optimized.

- It permits the local market development because of possibility of employment of more active actions than just an ATM waiting for the customers to come.

**The Virtual Bank**

**Description:**

This model is characterized for not having a physical network of branches. All the products and services would be accessed by the client electronically through phone, Internet or ATM. Some basic characteristics on this model:

- Each customer would have an individual account manager assigned, who would be the primary point of contact between the customer and the bank. All account managers would be based on one regional location, communicating with the customers (actual and potential) primarily by phone, and if necessary, the manager could go to the customer’s place.

- Managers could be assigned either by customers’ geographic location or by any other characteristic (age, income, etc), matching the profile of the manager with the segment’s characteristics.

- In case of necessity of physical transportation of material (checks, cash or documents), UPS, FedEx or other carrier would be used.

- All the back-office functions (clearing documentation, check-emission, etc) would be performed at the regional center.
Target Segment of Market:

- **Busy and sophisticated people**, who don’t have time to waste in a bank (or don’t want to), but need a personal account manager taking care of their accounts. The level of service expected at this segment of market is positioned on halfway between the standard retail banking and the sophisticated services offered by the financial boutiques.

- **High-tech lovers**, who have plain access to technology, and are intense users of e-commerce, and all the “state-of-art” ways of doing business.

- Regions with strong and/or **ascending economies**, where the population of entrepreneurs, up-moving and fast-paced professionals is significant.

Limitations and possible answers:

<table>
<thead>
<tr>
<th>Limitation</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Access to new customers, considering that the use of telemarketing is an undesirable procedure to use with busy people.</td>
<td>Specific advertising campaign associating good services with financial advantages (low fees, good rates).</td>
</tr>
<tr>
<td>Hard to build brand image without a physical network of branches (image of a fragile structure).</td>
<td>The association of this concept with the traditional bank will overcome this limitation.</td>
</tr>
<tr>
<td>Higher costs due to personalized services (better managers, home delivery, at-home services).</td>
<td>The absence of physical branches, associated with better allocation of managers to customers would compensate the additional costs.</td>
</tr>
</tbody>
</table>
Good because:

八大以来 This solution demands a lower investment (capital) in infrastructure than in a full branch model due to the possibility of using the existent physical structure at the bank, besides the fact that there is no need to build new branches.

月以来 It permits reaching a more sophisticated and profitable segment of market through the offering of upgraded services with well-trained personal account managers.

月以来 Flexibility to grow instantly because there’s no need to build (physically) the channel. It’s easier to expand the structure, installing more phone lines and hiring/training more people.

The Financial Mall

Description:

The financial mall is the generic name for a single location shared by two or more financial service providers: banks, mutual funds, insurance firms, etc. Not only the physical space could be shared, but also basic infrastructure (phone, data transmission) and maybe, part of the staff. The composition of the mall might be quite variable, ranging from a traditional full branch where part of the space was rented to related firms (selling insurance, mutual funds), to a “real mall” where many different banks and other financial service firms would have branches (full, ATM or lean).

Appropriate for:

 plainly Fast growing banks that don’t offer a complete line of financial services but want their customers served with a complete set of products and services. The bank only “virtually” provides the products and services, increasing the customer satisfaction with the bank, without having necessarily to build the business to provide them. In this case, the bank sponsors the mall, either renting part of the branch to other
providers, or building a space to install the bank and the other service providers separately.

⇒ Passage sites such as highways and shopping malls, where the public is not really "shopping" financial services (for instance, choosing a bank to open an account) but instead is looking for her usual service provider to get the desired product or service.

⇒ Places with seasonal concentration of people such as touristic places in high season (ski stations during winter and beaches during summer). The kind of relationship with the customers is the same as in the passage sites cases.

Limitations and possible answers:

<table>
<thead>
<tr>
<th>Limitation</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>When two or more similar financial service providers share the same space, there could be cannibalism (for example, one bank attracting others' customers, with no global gains for the mall).</td>
<td>Restrict the possibility of two banks at the mall just on the &quot;passage sites&quot; where the clients are looking for availability, and are not willing to move from a bank to another at that site.</td>
</tr>
<tr>
<td>There must be a sponsor for the project.</td>
<td>It could be either one of the participants (bank sponsoring to other services), or an outsider (entrepreneur) building and renting the mall.</td>
</tr>
</tbody>
</table>

Good because:

⇒ It is a lower cost and investment solution because of the use of common place and structure. In the case of a bank renting space at the branches, the income from the rental fees contributes to lower the branch’s operational costs.
It’s a referential for people wanting to shop financial services (one-stop-shop place), resulting in better sales yield at that place.

The presence of the bank at the “passage” malls helps to reinforce the image of availability of services, which is one of the reasons to grow the network of branches.

The Franchise Model

Description:
On the Franchise Model, instead of building and managing its branches and/or financial malls, a bank would franchise some (or all) of them. On this system, the franchisee would be granted with the right to explore commercially the brand name and use the bank’s business model (products, services, systems and procedures), after having paid an initial fee. As a franchisee, she would be the responsible for all the activities inherent to the operations of the branch: from the set-up to the daily management. The parent bank would sell its products and services through both the franchised and owned branches. The franchisees would profit with the margins (difference between interest received and paid) and fees received for selling services, and subtracting the operational costs (labor, fees paid and other expenses).

Appropriate for:
- High growth banks that don’t want (or can’t) to freeze large amounts of capital on building a large network of branches. As the required capital to open a new branch on the franchise system is indeed negative (the bank would receive a fee for each new branch), capital wouldn’t be a constraint anymore.

- Banks wanting to reach diverse segments of market while using a basic platform to gain with scale. It would be easier to shape a franchised branch to operate at a given level of services directed to a specific segment of market. The reasoning on this idea is that, because of the entrepreneurial nature of the franchise, a branch would operate
as a “small firm” whose culture is strongly influenced by its “CEO” – the franchisee. In the traditional model, it would be much harder to change the culture at just a group of branches, while maintaining the corporate culture at rest of the firm. The corporate culture would probably prevail over the local.

△ Changing corporate culture through the change on the paradigm at the management level. On the traditional way of managing a bank, decisions were made and informed to the staff. On the franchise model, decisions must be negotiated with the franchisees. This kind of relationship will eventually change (for better) the decisions making process because of the much more active role played by all the parts involved. Furthermore, as the franchisees are more likely to demand more efficiency from the bank, the traditional passive behavior pervasive at large commercial banks will tend to give space to a more active and aggressive behavior.

**Limitations and possible answers:**

<table>
<thead>
<tr>
<th>Limitation</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preserving the brand name without total control over the interface with customers (branches).</td>
<td>Contractual duties and rights will minimize this problem, but not eliminate. This is the main challenge in franchising.</td>
</tr>
<tr>
<td>Motivation of franchisees, given the necessary restrictive rules limiting their entrepreneurial spirit, besides the limited growth potential of a branch.</td>
<td>Open the possibility of growth through the acquisition of new franchises.</td>
</tr>
<tr>
<td>Credit risk management (who gets burdened in case of default).</td>
<td>This is badly addressed on the traditional model, in which the bank pays in case of defaults. On the franchised model this issue necessarily must be solved (see Fourth Chapter).</td>
</tr>
<tr>
<td>Other Limitations / Problems / Risks.</td>
<td>See Fourth Chapter for further discussions.</td>
</tr>
</tbody>
</table>
Good because:

- Negative capital investment (initial fee paid by the franchisee) eliminates the capital constraint to grow.
- Highly demanding franchisees will force the bank to respond more actively and so, become more competitive.
- Increase local responsiveness without compromising gains with scale.
- Focus more on the banking core business (finance, marketing and IT).
- See other benefits on the Fourth Chapter.

The problem of the coordination of channels

As it was mentioned at the beginning of the chapter, the higher diversification provided by different models for the distribution channel comes with a prize: the necessity of coordination to extract the benefits of diversification while avoiding bad competition and cannibalization among the channels.

The first step on coordinating channels is to understand the roles of each channel on improving the “customer experience” with the bank and, consequently, building a long lasting and valuable relationship with the customer. The following table summarizes the main focus in each of the described alternative and traditional models on the relationship of the bank with the customer. Before reading the table however, it is important to understand the meaning of the categories of contribution used on the table:

**Initiating** the relationship – It is the process of establishing a relationship with a new customer. This process involves getting awareness from that person, attracting her to the bank, and convincing her to become a new customer at the bank and buying at least one product or service.
Developing the relationship – Once the relationship is established, the stage of development starts. The goal here is to develop an intensive and profitable (long-term) relationship with the customer, offering and selling new products and services with the intuit of satisfying his needs and ultimately boosting the profits of the bank with this relationship, in short and long terms.

Maintaining the relationship – This stage refers to the effective delivery of the products and services, affecting directly the customer’s perception of quality through availability, reliability and comfort.

Below we have the table describing the segments targeted by each type of distribution channel, as well as their contribution considering the stages of the relationship bank-customer:

<table>
<thead>
<tr>
<th>Channel</th>
<th>Main Target Segment</th>
<th>Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bricks &amp; Mortar Branch (owned and franchised)</td>
<td>Higher margin customers, the most demanding for personal relationship on the maintenance and development stages, and the ones who best return the higher costs associated with this channel.</td>
<td>Initiating Maintaining Developing</td>
</tr>
<tr>
<td>“Direct Sales” (central divisions dealing with clients)</td>
<td>Large corporations and wealth persons, which demand more sophisticated products and services, and operate with larger volumes.</td>
<td>Initiating Maintaining Developing</td>
</tr>
<tr>
<td>ATM</td>
<td>Tech-educated, who are able to use the machines and take advantage of their lower costs and higher availability.</td>
<td>Maintaining</td>
</tr>
<tr>
<td>Internet</td>
<td>Lower margin tech-lovers, who give up personal services for the lower costs and the “at-home” convenience of Internet.</td>
<td>Initiating Maintaining Developing</td>
</tr>
</tbody>
</table>

Table continued on next page
<table>
<thead>
<tr>
<th>Channel</th>
<th>Main Target Segment</th>
<th>Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Virtual Bank</td>
<td>Higher margin tech-lovers, time and cost conscious but who do not give up some personal services.</td>
<td>Initiating Developing</td>
</tr>
<tr>
<td>Financial Mall</td>
<td>All</td>
<td>Maintaining Developing</td>
</tr>
<tr>
<td>Lean Branch</td>
<td>Lower margin customers, who frequently are tech-illiterates and need some level of personal attention, but are not profitable enough to justify a full branch.</td>
<td>Initiating Maintaining Developing</td>
</tr>
</tbody>
</table>

Once defined the roles of each channel on the process of building relationships with customers, the most effective way to coordinate the channels is to design a set of incentives in a way to motivate each channel to play predominantly its role as defined on the previous table. In addition to that set of incentives, it is necessary the existence of a central mediator that will arbitrate in case of explicit or implicit conflict between two channels, and adjust the set of incentives to avoid conflict of similar natures. Naturally, this role of mediator depends heavily on instruments to detect the conflicts, which in plain English means a collection of managerial information systems to monitor the channels.

An effective coordination of channels does not intend to eliminate completely the competition among the channels because this goal is either undesirable or feasible. Some degree of (good) competition among the channels is indeed desired because of the incentives in offering better services to the customers. We will see later on this paper that, for example, competition between franchised and owned branches may bring huge benefits to the bank as a whole, if well managed. Moreover, the complete elimination of competition among channels is not feasible because the market (customers) is not a static group and so, there must be some overlap between channels in order to capture the
moving customers. For example, a student is likely to be a target for the Internet channel while she is a student, but as soon as she graduates and grows on her career, she will be more likely a target for the Virtual Bank, for example. If these two channels were completely separated in order to avoid competition, during the transition this customer could “leak through the borders between channels”, that is, she could be attracted to the competition on the transition from one segment to the other. Therefore, the true goal on coordinating the channels is to minimize cannibalization and avoid bad competition among the different channels, and not to eliminate competition.

Finally, there is one particularly tough case on the coordination of channels, and which deserves a more detailed analysis: it is the case of cross-selling to different segments of market. A typical example is a firm (corporate account) and its managers (personal accounts) having a relationship with the same bank. The persons and the firm pertain to different segments of market, and so, should relate to different channels at the bank. However, those same persons are the ones who will act in the name of the firm when dealing with the bank, and will naturally expect especial treatment as a form of retribution for choosing that bank as a partner of the firm. The solution given to this case may vary according to the specific policies of each bank, but it must necessarily be coordinated in order to insure that one channel is not screwing up the other’s relationship. The usual way to do so is to use the cross-compensation, that is, if one channel is forced to offer better deals to its customer in order to preserve other’s relationships, the former must be compensated by the latter.
3. The Franchise Model

The Franchise Model will be analyzed in deeper details because, among the alternative models presented, it’s the one that can represent a real breakthrough on the banking business model, causing the greatest impact on the strategic positioning of a bank. The analysis of the model will be structured in a way to answer the following questions:

- How does the franchise system work, in general terms?
- How are the internal dynamics at a typical commercial bank?
- Who is responsible for each function at the franchise system?
- How are the costs and revenues allocated?
- What must be the boundaries for a franchisee at a bank in order to reach a good trade-off between entrepreneurial initiatives and corporate control?
- What are the minimum requirements for a bank to implement the franchise model?

In having these questions answered, the reader will hopefully understand how the franchise system would work in a bank, and will be able to proceed to the detailed project and implementation of the system at a specific bank. On the next chapters I will explore in great details the challenges faced by a bank in deciding to adopt the franchise system, as well as the potential benefits in this alternative.

The general functioning of the franchise system at banks

Franchising, according to the U.S. Department of Commerce, is a form of licensing by which the owner (the franchiser) of a product, service, or business method obtains distribution through affiliated dealers (franchisees). In return for the right to use the brand and the franchiser’s support in starting the business, the franchisee pays the franchiser an initial fee. In addition the franchisee usually pays a certain percentage from her gross revenue periodically for the continued support of the franchiser and use of brands, trademarks, or business format.
On the specific case of banking, instead of building and managing its own branches, a bank can franchise some (or all) of them. On the franchise model, the bank will be responsible for product development and licensing (when provided by third parties), production, and control; the franchisee will be responsible for sales of products and services. The parent bank will sell its products and services (directly supplied or not by the bank) through both the franchised and owned branches.

On this system, the franchisee would be granted the right to explore commercially (and fully manage) a site, using the bank’s brand name (flag) and use the bank’s business format (products, services, systems and procedures). In exchange for this right, the franchisee will pay an initial fee, which may vary according to the strength of the brand name, and the kind of initial support given to the franchisee during the setup period. In addition to the initial fee, a franchisee would have at least other two financial obligations: the first is the maintenance of a minimum capital deposited at the bank (in cash and/or bonds) in order to co-guarantee clients’ deposits in case of financial distress on the branch. The other financial obligation is related to the periodic fees paid to cover the continued business support (new products and services, brand enhancement, improvement on processes). Finally, there are the other contractual obligations which primary goal is to guarantee a continuing good and smooth relationship between franchisee and franchiser. These other contractual clauses may range from the obligation to commercialize only products offered and/or licensed by the bank (fidelity clause) to the obligation to use only the bank’s standards in architecture and layout at the branch.

The franchisees will profit with the margins on the money dealing segment (difference between interest received and paid) and fees received for selling services, and subtracting the operational costs (labor, activity based fees, other expenses) plus the periodical franchising fees. The cash-flow in a franchised branch will be basically the following:
The internal dynamics at a typical commercial bank

To better understand the details of the franchise model at a bank, it is crucial to have in mind what and how are the relationships among the various areas at a traditional commercial bank. In a bank, the boundaries between the sales and “production” are not as clear as those at the manufacturing sector, where the product is clearly packed, and it is the basis of the relationship between the production and the distribution. On the traditional model of managing distribution channels at banks, this problem of cloudy relationships among functions is frequently addressed through palliative “solutions” such as not evaluating functions separately, or turning variable costs into fixed costs. In franchising, as a third party will be inserted on the process, the relationship will have to be “cleared” because “real” money will be involved on the transactions between the bank’s areas and the franchised branches.
On the following section we have a general description of the typical relationships among the main functional areas at a commercial bank, considering the three basic functions described on the Chapter One:

**Bank as a Money Dealer:**

The scheme showed on the diagram below is commonly called by the name of Centralized Treasury because all the transactions involving cash-flow with clients must be cleared centrally at the treasury. This means that, for every investment a client makes (making a deposit on the checking account, buying a CD, etc), there will be an automatic "twin" internal transaction to transfer to the treasury the full amount of money invested, with the same maturity date, but with a different interest rate. At the maturity date, the principal and the internal interest are transferred back to the branch, and finally principal + external interest to the client. The branch keeps the spread between the internal and external interest. With loans the mechanism is similar, but on the opposite direction.

![Diagram 3.1 - Bank as a money dealer – internal dynamics](image)

*Diagram 3.1 – Bank as a money dealer – internal dynamics*
Bank as a Service Provider:

The diagram for service providing at banks shows the branch acting merely as a broker, and receiving a sales fee for the intermediation between the bank and the client. It is important to note that the Service Provider showed on the diagram not necessarily has to be the bank, that is, the branch may sell services provided by a third party. Some examples of services commercialized by bank’s branches but not initiated at the bank are credit card issuing, life insurance, investment banking (when the bank does not have an investment banking division), mutual funds, etc. The rational in offering products not provided by the bank through the branches is to offer the most complete range of services in order to improve the customer’s satisfaction with the bank’s flag. In addition to strengthening the brand, the sales of services provided by third parties may incentive the sales of products or services provided by the bank. An example of this kind of situation is when a bank sells investment banking services provided by an investment bank, and the resultant project involves some kind of financing that can be provided by the bank that originated the deal.

![Diagram 3.2 – Bank as a service provider – internal dynamics](image)

Bank as a Proprietary Portfolio Manager (Market Risk Taker):

The goal on the proprietary portfolio management function is to take market risk positions in order to seize opportunities created by the relative movements on prices of assets and derivatives on the market. This function is the least commercial oriented among the three functions here described, a characteristic that explain why it is generally more important in investment banks (trading division) than in commercial banks. It is
important to differentiate the proprietary treasury, which is responsible for taking risks and gain with market movements, from the called structural treasury, which is responsible for managing/hedging risks and cash-flows originated from transactions with clients, showed on the diagram “Bank as a Money Dealer”.

Diagram 3.3 – Bank as a proprietary portfolio manager – internal dynamics

**Matrix of responsibilities at the franchise system**

In the traditional model, the bank is responsible for all the functions performed inside the bank, from real estate, when building a new branch, to the sales of products at the branches. On the franchise system, part of the functions will be the responsibility of the franchisees in terms of management, implementation and costs. On the following matrix of responsibilities I describe some of the most important dynamics of the franchise system at banks.
Matrix of Responsibilities at the Franchise System:

<table>
<thead>
<tr>
<th>Start-up</th>
<th>Bank</th>
<th>Franchisee</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Select franchisee.</td>
<td>✓ Pay branch set-up costs (building, infrastructure, etc).</td>
<td></td>
</tr>
<tr>
<td>✓ Select location of the branch to be franchised.</td>
<td>✓ Deposit the minimum capital required by the bank to guarantee deposits.</td>
<td></td>
</tr>
<tr>
<td>✓ Define standard architecture and internal layout.</td>
<td>✓ Manage the set-up process, using or not the bank’s support.</td>
<td></td>
</tr>
<tr>
<td>✓ Train staff of the branch on banking subjects such as products, services and operations.</td>
<td>✓ Recruit, select and hire personnel.</td>
<td></td>
</tr>
<tr>
<td>✓ Supply specific IT Structure: credit analysis, transactions data entry, agenda, clients’ activity analysis, etc.</td>
<td>✓ Prepare staff in terms of general training (sales techniques, management, etc)</td>
<td></td>
</tr>
<tr>
<td>✓ Negotiation with large suppliers (IBM, Microsoft) to get volume discounts.</td>
<td>✓ Prepare administrative structure of the branch (accounting system, security system, etc), with the bank’s support.</td>
<td></td>
</tr>
<tr>
<td>✓ Supply of specific hardware such as ATM’s and standard teller equipment.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>✓ Give support to franchisee to prepare administrative structure of the branch (accounting, security system, legal issues, etc).</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Credit Analysis</th>
<th>Bank</th>
<th>Franchisee</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Development of credit analysis system (model, database, IT and procedures).</td>
<td>✓ Make the final decision about giving or not credit, after approval from the system.</td>
<td></td>
</tr>
<tr>
<td>✓ Enter general data on the database (economic, commercial, and social).</td>
<td>✓ Gather ‘subjective’ data and enter on the database.</td>
<td></td>
</tr>
<tr>
<td>✓ Define of the level of premium to cover credit risk for each level of risk.</td>
<td>✓ Gather documentation.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>✓ Enter client specific data on the database, being liable for bad quality of the data entered.</td>
<td></td>
</tr>
</tbody>
</table>
Matrix of Responsibilities at the Franchise System (continued):

<table>
<thead>
<tr>
<th>Bank</th>
<th>Franchisee</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Legal procedures to enforce payment.</td>
<td>✓ Account losses due to the default: partial value of the total loss (percentage defined on the contract between bank and franchisee).</td>
</tr>
<tr>
<td>✓ Account losses due to the default: partial value of the total loss (percentage defined on the contract between bank and franchisee).</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Credit - Default</th>
<th>Credit Funding and Interest Rates Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Control of the outflow of money through changes on the cost of money (basic rates charged to the branches on the internal transference of funds due to loans).</td>
<td>✓ Fund automatically any loan given by the franchised (and owned) branches, with matched maturity and other parameters.</td>
</tr>
<tr>
<td>✓ Definition of the cost of the money (based on the market interest rates and strategy of controlling the outflow of money).</td>
<td>✓ Get fund to the loan conceded, with deposits and/or on the financial market.</td>
</tr>
<tr>
<td>✓ Manage the position created by the loan in terms of maturity mismatches (liquidity and market risk management).</td>
<td></td>
</tr>
</tbody>
</table>

✓ Negotiate the final rate (including all its components) with the client, and occasionally with the treasury to get better rates for the customer.
Matrix of Responsibilities at the Franchise System (continued):

<table>
<thead>
<tr>
<th>Credit Control</th>
<th>Franchisee</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Accounting of the transaction from the bank’s point of view (internal loan to the branch).</td>
<td>✓ Perform all the bureaucratic procedures: contract signature, file, etc.</td>
</tr>
<tr>
<td>✓ Supply clients periodically with updated reports of the outstanding loans.</td>
<td>✓ Update the control system with the new transaction.</td>
</tr>
<tr>
<td></td>
<td>✓ Manage the loan, acting accordingly to the events: maturity, anticipation, postponement, renegotiation and default).</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Investments and Deposit Accounts</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Control of the inflow of money through changes on the basic rates paid to the branches on the internal transference of funds due to deposits and investments.</td>
<td>✓ Convince customer to leave or invest her money on the bank (sell the bank’s products).</td>
</tr>
<tr>
<td>✓ Define basic rate that will remunerate the deposits and other investments.</td>
<td>✓ Negotiate the rate to be paid to the client, based on basic rate the bank offers to the branches minus a spread. In addition, occasionally negotiate with the treasury to get better rates for the customer.</td>
</tr>
<tr>
<td>✓ Invest funds on the financial market or lend to other clients.</td>
<td>✓ Manage the clients’ investments, making investment suggestions, warning about incoming maturity dates.</td>
</tr>
<tr>
<td>✓ Transfer automatically any investment or deposit received by the franchised (and owned) branches to the bank central account, with matched maturity and other parameters.</td>
<td>✓ Perform all the bureaucratic procedures: contract signature, file, etc.</td>
</tr>
<tr>
<td>✓ Manage the position created by the deposit or investment, in terms of maturity mismatches (liquidity and market risk management).</td>
<td>✓ Update the control system with the new transaction.</td>
</tr>
<tr>
<td>✓ Provide periodical reports to the client about the current investments and deposits.</td>
<td>✓ Manage the loan, acting accordingly to the events: maturity, anticipation, postponement, renegotiation and default).</td>
</tr>
</tbody>
</table>
Matrix of Responsibilities at the Franchise System (continued):

<table>
<thead>
<tr>
<th>Services Providing</th>
<th>Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Provide service: check emission, portfolio management, mutual funds management, credit card, bill collection, investment banking, and private banking.</td>
<td></td>
</tr>
<tr>
<td>✓ Define the fees to be charged for the services supplied.</td>
<td></td>
</tr>
<tr>
<td>✓ Define the fees paid to the branches for selling the service.</td>
<td></td>
</tr>
<tr>
<td>✓ Define which services not provided by the bank will be supplied from third parties and sold through the branches.</td>
<td></td>
</tr>
<tr>
<td>✓ Select external providers and negotiate the terms of the contract.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Franchisee</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Sell services.</td>
</tr>
<tr>
<td>✓ Update control systems with the information about services sold.</td>
</tr>
<tr>
<td>✓ Suggest new services (financial or not) to be sold through the branches.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Marketing</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Create new products and services, based on market research, channel feedback and changes on the competitive environment.</td>
<td></td>
</tr>
<tr>
<td>✓ Improve existent products and services.</td>
<td></td>
</tr>
<tr>
<td>✓ Advertising: product specific or institutional to strength brand.</td>
<td></td>
</tr>
<tr>
<td>✓ Regulate ALL the official communication between the bank and the market.</td>
<td></td>
</tr>
<tr>
<td>✓ Internal (inter-branches) promotions to incentive sales.</td>
<td></td>
</tr>
<tr>
<td>✓ Create mechanisms to stimulate branches (franchised or owned) to invest in building long-term relationship with the customers.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Franchisee</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Distribution (sales and feedback to the marketing division).</td>
</tr>
<tr>
<td>✓ Primary contact with customers.</td>
</tr>
<tr>
<td>✓ Building the long-term relationship with the customer, adding long-term value to the business (the branch and ultimately the bank).</td>
</tr>
<tr>
<td>✓ Definition of the retail price of money.</td>
</tr>
<tr>
<td>✓ Internal (branch) promotions.</td>
</tr>
</tbody>
</table>
Matrix of Responsibilities at the Franchise System (continued):

<table>
<thead>
<tr>
<th>Bank</th>
<th>Franchisee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Branch Operations</td>
<td>Management of the level of services at the branch level (queues and demand management).</td>
</tr>
<tr>
<td></td>
<td>HR management.</td>
</tr>
<tr>
<td></td>
<td>Operational costs.</td>
</tr>
<tr>
<td>✓ Definition of general procedures.</td>
<td></td>
</tr>
<tr>
<td>✓ General support to the branch in terms of security, HR management, accounting and other administrative matters.</td>
<td></td>
</tr>
<tr>
<td>H.R.</td>
<td>Recruiting, hiring and firing.</td>
</tr>
<tr>
<td>✓ Specific banking training.</td>
<td>Legal duties and liabilities.</td>
</tr>
<tr>
<td>✓ Support to the branches when recruiting, specially in printed ads and other forms of communication.</td>
<td>Staff training.</td>
</tr>
<tr>
<td></td>
<td>Salary and benefit costs.</td>
</tr>
</tbody>
</table>
Costs and revenues allocation at the franchise system

Even though the problem of costs and revenues allocation is one of the most important aspects on the management of any business, on the franchise system it is particularly relevant due to the fact that “real” cash flow between two separate firms (bank and franchisee) is involved. This allocation is determinant on the profits of both firms, and may become a determinant factor of attractiveness of new (and good) franchisees to the system. Not to mention that it also affects directly the bank’s profitability.

Furthermore, the way costs and revenues are allocated is crucial to the alignment of interests in both firms. A good example of the importance of a good project of cost and revenue allocation is the case of credit concession. If on one hand a franchisee’s revenue is proportional to the interest rate a client pays for a loan, but on the other hand she does not take part on the losses in case of default, she will have all the incentives to concede bad credits. This happens because the clients who are willing to pay the highest interest rates for the loans are those in the worst side of the credit rating distribution. Given that a franchisee can not be laid off, and that her main motivation driver is profit (no long term career goal or any other soft motivation factor), the best way to avoid that kind of bias is to design an accurate and fair allocation of costs and revenues for each product and service.

On the allocation proposed below, the goal is not to specify a detailed project of costs and revenues allocation, but rather to propose a general framework to be used when defining the true cost allocation scheme. The details such as exact percentages, costs, and a comprehensive list of products and services must be subject of specific analysis in each case (bank + market).

Loans:

Includes all sorts of credit concession, from personal and corporate vanilla loan, to the corporate project financing.
Case 1 – Client pays at the maturity date:

<table>
<thead>
<tr>
<th>Bank</th>
<th>Franchisee</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td><strong>Franchisee</strong></td>
</tr>
<tr>
<td>Rate paid by the branch =</td>
<td>Rate paid by the client =</td>
</tr>
<tr>
<td>Internal Cost of money +</td>
<td>Internal Cost of Money +</td>
</tr>
<tr>
<td>X% Credit Premium +</td>
<td>Credit Premium +</td>
</tr>
<tr>
<td>Clearing Fees</td>
<td>Clearing Fees +</td>
</tr>
<tr>
<td>Costs</td>
<td>Branch Profits</td>
</tr>
<tr>
<td>Funding Cost +</td>
<td>Branch’s Operational Expenses +</td>
</tr>
<tr>
<td>Operational Expenses</td>
<td></td>
</tr>
</tbody>
</table>

Case 2 – Client pays after the maturity date:

<table>
<thead>
<tr>
<th>Bank</th>
<th>Franchisee</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td><strong>Franchisee</strong></td>
</tr>
<tr>
<td>Rate paid by the branch =</td>
<td>Rate paid by the client =</td>
</tr>
<tr>
<td>X% Delay Charges</td>
<td>Delay Charges</td>
</tr>
<tr>
<td>Costs</td>
<td>Rate paid by the branch =</td>
</tr>
<tr>
<td>Funding Cost +</td>
<td>X% Delay Charges +</td>
</tr>
<tr>
<td>Operational Expenses +</td>
<td>Branch’s Operational Expenses +</td>
</tr>
<tr>
<td>Delay Expenses</td>
<td>Branch’s Delay Expenses</td>
</tr>
</tbody>
</table>

Case 3 – Client does not pay at all (default):

<table>
<thead>
<tr>
<th>Bank</th>
<th>Franchisee</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td><strong>Franchisee</strong></td>
</tr>
<tr>
<td>X% Collateral Value</td>
<td>Collateral Value</td>
</tr>
<tr>
<td>Costs</td>
<td>Rate paid by the branch =</td>
</tr>
<tr>
<td>Funding Cost +</td>
<td>X% Principal</td>
</tr>
<tr>
<td>Operational Expenses +</td>
<td>Branch’s Operational Expenses +</td>
</tr>
<tr>
<td>X% Principal</td>
<td>(1-X%) Principal</td>
</tr>
</tbody>
</table>
### Glossary:

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal Cost of Money</td>
<td>Interest rate the bank (treasury) charges the branches for new loans. It may be higher or lower than the Inter-banks Interest Rate, depending on the strategy adopted on management of the cash-flow.</td>
</tr>
<tr>
<td>Credit Premium</td>
<td>Premium over the cost of money depending on the client’s rating, to cover potential losses in case of default.</td>
</tr>
<tr>
<td>X%</td>
<td>This is the distribution of the responsibilities on the credit concession. The bank is responsible for X% of the losses in case of default and delay; the franchisee is responsible for (1-X%). Accordingly, the bank will keep X% of the Credit Premium, Collateral Value, or any other revenue or expense related to defaults or delays in credit.</td>
</tr>
<tr>
<td>Branch’ Profits</td>
<td>This is a “spread” over the total cost of the loan, which will depend on the market demand for loans, and the branch strategy for the specific deal (long-term interest on that customer – relationship building). Naturally, the skills of the account manager in selling the product also affect this item.</td>
</tr>
<tr>
<td>Clearing Fees</td>
<td>Fees charged by the bank for the services of clearing the loan. This includes the contractual costs, transfer of funds, etc.</td>
</tr>
<tr>
<td>Funding Costs</td>
<td>The cost of money from the bank’s point of view. It may be higher or lower than the Inter-bank Interest Rate, depending on the strategy adopted on the portfolio management, and the liquidity of the market for the specific duration of the loan.</td>
</tr>
<tr>
<td>Delay expenses</td>
<td>Additional expenses associated with delays on the payment of a loan. Some examples are the costs to fund the loan for the period of delay, legal procedures, etc.</td>
</tr>
<tr>
<td>Collateral Value</td>
<td>Proceeds from the sale of the collateral goods (if any).</td>
</tr>
</tbody>
</table>
**Investments:**

Includes CD’s, saving accounts and all sorts of investments available. This category does not include mutual funds given that this is more a service (portfolio management) that a bank may offer to its clients.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Franchisee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>Internal Cost of Money</td>
</tr>
<tr>
<td>Funding Cost + Clearing Fees</td>
<td></td>
</tr>
<tr>
<td>Costs</td>
<td>Rate paid to the client +</td>
</tr>
<tr>
<td>Internal Cost of money +</td>
<td>Branch’ Operational Expenses +</td>
</tr>
<tr>
<td>Operational Expenses</td>
<td>Clearing Fees</td>
</tr>
</tbody>
</table>

**Glossary:**

| Rate paid to the client | Internal Cost of Money – Branch’ Operational Expenses – Clearing Fees – Branch Profits |

**Service Providing:**

Includes all the services offered by the bank, ranging from bill collection to M&A services. The only role of the branch in this case is that of an intermediary between the bank and the customer.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Franchisee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>Brokerage Fee =</td>
</tr>
<tr>
<td>Service Fee =</td>
<td>Sales Expenses +</td>
</tr>
<tr>
<td>Service Providing Expenses +</td>
<td>Branch Profit</td>
</tr>
<tr>
<td>Brokerage Fee +</td>
<td></td>
</tr>
<tr>
<td>Bank Profit</td>
<td></td>
</tr>
<tr>
<td>Costs</td>
<td>Service Providing Expenses +</td>
</tr>
<tr>
<td>Service Providing Expenses +</td>
<td>Sales Expenses</td>
</tr>
<tr>
<td>Brokerage Fee</td>
<td></td>
</tr>
</tbody>
</table>
Glossary:

Service Fee  | Cost negotiated with the client for the services provided by the bank. When the franchisee gives a discount on the fee charged to the client, this discount must be distributed evenly between the Brokerage Fee and the Bank Profit.

Brokerage Fee  | Cost to the bank for having its services sold through the branch.

Infrastructure and Other Internal Services Provided

| Bank                          | Franchisee
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>Fixed Monthly Fee Fee / Transaction</td>
</tr>
<tr>
<td>Costs</td>
<td>Fixed Monthly Fee Fee / Transaction</td>
</tr>
<tr>
<td>Fixed and variable costs:</td>
<td>Fixed Monthly Fee Fee / Transaction</td>
</tr>
<tr>
<td>Marketing</td>
<td></td>
</tr>
<tr>
<td>IT</td>
<td></td>
</tr>
<tr>
<td>Back-office</td>
<td></td>
</tr>
<tr>
<td>Treasury</td>
<td></td>
</tr>
</tbody>
</table>

Glossary:

Fixed Monthly Fee | Fees paid by the branches for the use of general infrastructure, brand name building, etc.

Fee / Transaction | Fee paid by one branch to the other when the latter branch provides services to the former's clients, based on the variable costs and on the profit with the specific transaction (ATM, bill payments, etc).
Aligning the incentives of the franchisees with the bank’s strategy

As it happens in any corporation, the franchisee often faces the dilemma of having to sacrifice short-term profits in order to create long-term value for the firm (franchisee and ultimately, the bank). On the specific case of banks, this long-term value is completely embedded on the long-term relationships with the valuable customers, developed through providing good products and services to the good customers (current and potential), and repelling the bad ones. An effective system of cost and revenue allocation must be designed in way to incentive the franchisees to tend toward the direction of the long-term value creation, aligning her incentives with the bank’s strategy. The generic cost & revenue allocation previously proposed has some features that are intended to solve some problems of misalignment of incentives commonly found in commercial banks.

On the credit concession, the credit risk premium embedded on the rate paid by the client is split between the franchisee and the bank, with the ratio of X% to the bank and (1-X)% to the franchisee. On the other hand, in case of delays or default on the payment of the loan, bank and franchisee will split the losses at the same proportion as they split the risk premium (X%). Without this scheme of splitting revenues and losses, the franchisee would be encouraged to give as much credit as possible in order to increase revenues, attracting bad clients and increasing the bank losses with credit. Thus, the establishment of shares of participation on the upsides (risk premiums) and downsides (losses) has two equally important benefits: on the mid-term, the bank losses with bad credit will tend to decrease due to the higher conservatism of the franchisees in conceding credit. On the long-term, the overall quality of the portfolio of customers will improve as a consequence of the joint efforts of both bank and franchisees in selecting good credit takers. These two benefits are indeed part of a reinforcing system in the sense that the better quality of the portfolio of clients (in terms of credit), the lower the overall cost of credit. The lower costs will eventually reflect on more competitive rates to the clients, which will be an
additional factor to attract the most valuable customers, and so forth.

On the allocation of revenues & costs scheme proposed for the service providing, any "investment" in building long-term relationships with clients - in the form of discounts on the service fees - is split between the bank and the franchisee. The goal here is to incentive the branch to create long-term value with the financial support from the bank, even with apparent losses on the current profits. With this scheme of allocation, the bank can exert an indirect control on the behavior of the franchisees. For example, if the bank's strategy is to build relationships with graduate students because of their future economical potential, the mix on the split of the discounts may be changed, increasing the proportion paid by the bank. The issue here is to incentive the branch not only to sell as much services as she can but also to build long-term relationships with valuable customers, a behavior that is beneficial to both bank and franchisee.

When one branch provides services to other's customers, the former must be compensated in order to cover the expenses with that specific transaction, besides resulting in some profit to the provider of service. This cross-compensation is necessary to incentive all the branches to offer equal treatment to all customers, independently from their primary point of contact with the bank. Naturally, if one branch were not compensated when providing a service to other's customer, it would have all the incentives to repel that client, threatening the relationship of the client with the bank.

Finally, there is one aspect on the franchising system that is crucial in aligning the interests of the franchisees with the bank's strategy, which is the fact that a franchisee must be able to sell his business if he wants to. As the price of the franchise will probably be determined by the future cash-flow generated by that branch at the moment of the sale, the franchisee is not willing to destroy value exhausting completely the potential of his portfolio of clients. The franchisee's actions will be driven not only by current profits but also by creation of future value, depending on which alternative adds a higher present value to the business. This kind of behavior is exactly the recommended on the good
books of business administration: taking decisions based on the net present value of the projects, independently if it is a new nuclear power plant or a new checking account for a student.

**The boundaries at the franchise model**

Another important aspect to be considered on the franchise system is the definition of boundaries to limit franchisee actions to a safe territory. This is particularly important in banks due to the sensitivity of clients with the bank's image: at the minimum signal of problem (real or not), the customers rush out the bank to a seemingly safer place. Thus, a strict control of franchisee’s actions is not only desirable but also a matter of survival.

Nonetheless, the franchisee is an entrepreneur by nature, and so, may get unmotivated if she can’t exercise her entrepreneurial spirit because of a strictly controlled environment. Therefore, it is necessary to let contractually explicit the boundaries where she can (and must) use her initiative and where she cannot, in order to reach a good trade-off between the entrepreneurial initiatives from the franchisees, and the preservation of the bank’s image.

The following section will be dedicated to explore some of the basic and general boundaries that must be defined explicitly on the franchise contract in order to avoid problematic behaviors by the franchisees, and to leave space for healthy initiatives.

*The Franchisee can:*

- Manage actively her portfolio of clients through cold calls to attract new clients or sell different products, “soft” amenities at the branch such as coffee, VIP rooms, delivery services of documents, personalized services such as account manager visiting clients at home, and basic financial advice.
Negotiate rates and prices with clients, knowing that her share of the total profit will be burdened on that transaction if she lower the prices too much. Sometimes the franchisee may prefer to have a loss in one specific transaction in order to get profits from the long-term relationship with the customer.

Negotiate better rates and prices with the treasury or with other service provider at the bank. This kind of negotiation not only is permitted but also should be encouraged by the bank, because one of the main roles of a distribution channel is giving feedback to the bank. When negotiating better rates with the bank, the franchise is indeed keeping the central divisions (treasury, marketing, etc) informed about the real status of demand in terms of price sensitivity.

Demand aggressively from the bank, better products, services, fees, etc. This is related to the previous item, but in broader terms. A large part of the advantages of franchising branches is that the franchisees, being the owners of their business, will be much more demanding than a regular branch manager, pushing the quality of the bank businesses toward the direction of higher quality and competitiveness.

Refuse giving credit even with the approval from the credit system. Case the eye-to-eye “analysis” made at the moment of the negotiation points to a “no-go” decision, the account manager (or the franchisee) must be autonomous to take this decision. Furthermore, the account manager should definitely be able to feed the credit analysis system with the rational that lead her to make such decision, even if completely subjective.

Manage the staff according to the branch necessities, implementing new procedures and organizations. The only restriction here is to respect the minimum quality of service defined on the contract signed with the bank. Depending on the contract, a maximum size of lines in front of the teller, or maximum time to service may be defined. Nevertheless, if the franchisee can manage to reach the minimum
quality levels at a lower cost, with fewer people, or with an optimized organization, he is free to implement it, and suggest the bank to extend the model to the rest of the bank.

Franchise more than one branch. As we will see later, the potential to grow through the acquisition of more branches is the main motivational factors for franchisees. Considering that there is little room to grow the business through the increase on the profits of one branch, the only way a franchisee can grow aggressively is expanding the number of branches she owns. One important aspect the franchiser must think in is to limit the number of branches a franchisee may control, in order to preserve the bank's power position when negotiating with the franchisees.

Sell the franchise, either to the bank or to a third party approved by the bank. There are a number of reasons why a franchisee would be willing to sell the franchise: a good offer, bad performance, retirement, etc. Therefore, it is natural that the franchisee be able to divest whenever is needed or wanted in order to guarantee the continuity of the business, and more importantly, to incentive the building of long-term value because of the possibility of sale of this potential value to third parties. Naturally, the selection of the potential buyers of the franchise is so important as it was the selection of the initial franchisee and so, the bank must have complete control on this process. An easier (but not necessarily better) alternative would be to restrict the sale of the franchise back to the bank, a solution that would eliminate the problem of synchronizing the selection of the buyer to the necessity of the seller. However, the big drawback on this alternative is the fact that the bank would have the monopoly on buying back its franchises, creating the necessity to define on the franchise contract the criteria to price the franchise in case of sale, to protect the franchisees' rights. These criteria should be perfectly designed in order to align the implicit incentives represented by the price factors to the strategy of the bank.
The Franchisee cannot:

⇒ Distribute printed material without approval from the bank’s marketing department. The problem with printed material is that there is no way to control its power once it is on the market. Hence, printed material may cause serious damages to the institutional image of the bank in case of bad quality or misleading advertisement. Moreover, considering that the bank’s marketing division is technically more capable than the franchisee on this issue, it makes more sense to centralize this function. This issue of institutional communication is one of the most important (and delicate) on the definition of the franchisee’s boundaries.

⇒ Sell products not supplied by the bank, without contractual approval from the bank. The banking market is rich in products that seem to make much sense to be sold in a bank branch, and thus, the franchisees could be tempted to sell them to get economies of scope. There are two important aspects on this issue: the first is legal and the other is strategic. The legal aspect is especially important on such a regulated segment as the commercial banking, where up until few years ago it was prohibited, for example, the sales of mutual funds by banks. On the strategic side, the mix of products sold by a bank is a question of marketing positioning, which must be decided at the corporation level.

⇒ Give credit without formal approval through the credit system. This delicate issue involves more than simply defining the boundaries of actions, but defining to ethical behavior. Considering that both parties (bank and franchisee) are liable in case of default of a loan, both parties must jointly decide in giving or not giving credit. The formal approval is the mechanism used for the bank to decide in giving the credit. Because of the potential of conflicts and damages related to this issue, it must be strictly enforced on the contracts.

⇒ Change layout at the branch without permission from the marketing division.

The layout of the branch is directly linked to the institutional communication with the
market. Moreover, if the change is just intended to optimize branch’s operations, it is healthy that the bank be informed about knew possibilities to extend the best ideas to the whole network.

⇒ **Give credit if all the branch’s limit of credit risk has already been used.** The pre-establishment of a limit for the branch’s exposure to credit risk has two intentions: the first is to assure the financial health of the branch in case of large number of customers in default. The second is that banks must respect a pre-established limit of exposition to credit risk (bank regulations), and so, the franchised branches will have to conform to this rule as well.

⇒ **Be other banks’ franchisee.** The relationship bank-franchisee is based in intense exchange of confidential information about the strategy and operations of the business, and hence the possibility of one person (or group) being a franchisee at two different banks must be discharged. Besides the confidentiality of information involved, there would be problems related to anti-trust laws.

**Minimum requirements to implement the franchise model**

From what we saw on the description of the franchise system, some exigencies must be satisfied in order to assure the success on the implementation of the new model, with special emphasis on the transparency of the relationships between internal divisions. It is not obvious that all these exigencies can be promptly fulfilled by a commercial bank using the traditional model, and so, there must be some adjustments to be done on the bank’s structure before the implementation of the franchise model. On this section I will explore some of the basics requirements a bank must meet before start thinking in adopting the franchise model.
Distribution Channel Management:

- Model of channel coordination establishing the zones in which each distribution channel must focus its efforts, and the “forbidden zones” for each channel. The problem of coordinating distribution channels becomes more delicate with the franchise model because of the competitive nature of the franchisees. To avoid problems such as a branch refusing to provide services to other branches’ clients, or large clients with offices in more than one place not receiving a uniform quality of services, it is necessary that all the distribution channels be coordinated effectively by a central division. Some important cases that this coordination model must contemplate are:

  - A branch supplying services to others’ customers must be rewarded with an amount covering the total costs and a defined participation on the profits with that specific transaction.

  - The set of (potential or actual) clients composed by large corporations must be addressed separately from the others when designing a model for channel coordination. The reason for this special care is that these clients often have offices in different locations – being potential customers for more than one branch – and have too much bargain power when compared to the branch’s. Because of these characteristics, banks frequently adopt the policy of creating special channels to deal directly with this kind of client, creating a “forbidden zone” for the branches.

Cost Accounting and Performance Metrics:

- Cost allocation model that establishes clearly and explicitly ALL the costs direct or indirectly related to a branch operation (from IT cost per transaction to cost of legal actions against clients in default). On the cost accounting at large banks it is common to find some “gray” areas sometimes called “other costs”, or “corporate
fixed costs”. These areas are generally accepted by the management because this problem is “similar to knowing how much money we have, but not knowing how much money we have in each pocket”. On the franchise system, this attitude toward cost accounting is not possible because the bank will not own one of the “pockets”, and so, money put or taken from that specific “pocket” is money in and out of the bank.

⇒ Model to measure individual performance of the branches. Even though this should not be a specific issue on the franchise model, the definition of objective metrics to measure the performance of branches is particularly important here because they (the metrics) will be part of the contractual agreement between bank and franchisee. As it was mentioned more than once on this document, a franchisee can not be just laid off by the bank in case of “poor” performance if this was not established on the franchising contract. Furthermore, the definition of “poor” must be completely objective in order to be strictly enforced in case of problems with franchisees. On the franchisee side, the objective definition is also desirable because it gives her the autonomy to change the branch management, given that the minimum levels of performance are satisfied (and the boundaries are respected).

Credit Analysis:

⇒ Model of Credit Analysis, contemplating Customers Credit Rating and Limit, Risk Premiums and Credit Risk Limits to the branches. Being one of the most delicate functions of the commercial banking business, the use of an objective and precise model of credit analysis is crucial to the bank’s survival, either on the franchise or on the traditional models. The difference on the franchise system is that the credit analysis model must be used in 100% of the cases, while on the traditional model there are some (unhealthy) instances of account managers bypassing the formal credit analysis. (“I know him since he was a kid, so let’s forget the credit rating for a while”)
The first function such model should perform is the rating of all the customers according to their capability of paying back the loans. This rating process must be based mostly on the quantitative analysis of specific data related to that customer, complemented with economic data analysis. At least two pieces of information must result from this client-specific analysis: the attribution of a credit rating class to the client, and the limit ($) of credit for this client. Complementing the specific client analysis, it is necessary also to define the level of risk premium in each class of credit rating. The risk premium will be used when defining the final interest rate to be asked when conceding a loan. Finally, a limit ($) of exposure to credit risk must be attributed to each branch, according to the financial structure of the branch (capital size, cash flow, etc.). The utilization of this limit will have to be periodically updated with the new loans conceded (the impact on the utilization will be proportional to the amount of money lent and the quality of the credit conceded – which is linked to the customer rating). This last function is called credit risk control.

⇒ Procedures in credit concession to enforce the compliance with the model defined. This requirement seems to be redundant with the previous one, but it is important that the procedures be defined in the most explicit manner as possible. It is even advisable that part of the procedure be present on the franchising contract in order to establish possible penalties in case of misconduct. Moreover, a clear procedure defined since the beginning of the relationship between bank and franchisee will avoid complaints about the “lack of the flexibility on credit concession”, a very common complaint from the account managers on the traditional model when justifying deviations from the formal procedures.

Treasury Management:

⇒ Separation of the structural portfolio management (positions generated by operations with clients) from the proprietary portfolio management (positions generated by the treasury to seize a market opportunity – potential gains with
market risk). This requirement is related to the cost accounting issue because the gains (or losses) resulted from taking market risk must be isolated from the costs and revenues on the money dealing business (giving/taking money to/from the customers). Therefore, it is possible to distinguish the real cost of money only if this portfolio is completely hedged, and the revenues on the assets minus the expenses on the liabilities represents the real profit with transactions with clients. To accomplish this separation of the profit and loss sources, it is necessary that a person (or group) be responsible for hedging the structural position, and another person (or group) be responsible for taking market risks in order to seize favorable movements of prices and rates.

⇒ Models to manage market risks (control and hedge). This requirement is the basic condition to accomplish the previous requirement of separation of the structural portfolio from the proprietary portfolio. On a portfolio of operations with clients (loans and investments), there are thousands of different maturity dates in both asset and liability sides. Hedging each individual maturity date of this portfolio would not be viable because of the transaction costs and so, the hedging process must be performed with the support of a risk management model. With this kind of model it is possible to calculate the exposure to market risk of the whole portfolio, and more importantly, it is possible to hedge the entire structural portfolio with just a few transactions.

Information Technology:

⇒ Communication and data structure to support all the models and procedures required. The viability of the models suggested previously, as well as the feasibility of enforcing all the necessary procedures will depend strongly on the availability of a carefully planned IT structure. A robust data-warehouse is crucial to support the cost accounting, performance, credit and risk management models. In addition, it is necessary a structure to permit real-time communication between the central agents
(treasury, marketing, etc.) and the branches, to inform updated rates, transfer funds in new operations, update limit utilization, get credit approval for the customer, enter and distribute information about customers, markets, etc.

**Corporate Culture / HR Management:**

⇒ **Openness to changes and accept new ideas.** On the franchise system, a highly entrepreneurial element (the franchisee) is inserted on the structure of the bank and, in order to keep the stability of the structure is necessary that the bank be open to changes and new ideas. The minimum requirement is that initially at least the management of the bank be open to new ideas, and with the evolution of the franchise system, the flexibility and openness will eventually pervade the corporate culture.

⇒ **Willingness to negotiate ideas and decisions (contrasting with imposing them).** The franchise model will cause a big shift on the management paradigm: ideas and decisions will have to be negotiated with the franchisees instead of being “informed” (or imposed) as it was the “natural way” on the traditional model. As the franchisees buy (on the economic sense) the new ideas / decisions from the bank, they want to get the best product for the lowest price possible. This new kind of relationship will succeed only if the management is open to negotiate the ideas.

⇒ **Structure for intensive training of the franchisees and branches employees.** The bank must be prepared to be a truly supplier of training and consulting to the franchisees, with appropriate people and structure to perform this new function.
4. Benefits and Challenges on the Franchise Model

Now that we have a clearer idea about the functioning of the franchising system at banks, it is a good time to discuss the benefits – quantitative and qualitative - brought by this innovative system, as well as the most important potential challenges faced by banks when adopting the franchising system.

Benefits on the franchise model

Economical / financial

⇒ Negative initial capital investment (initial fee paid by the franchisee).

On the traditional model, for each branch opened the bank must invest a certain amount of capital to acquire or lease the real estate property, buy equipment, hire and train people, or in short, to start up the branch. Naturally this investment will eventually payoff in a period of time, but on the mean time, that invested capital stayed frozen on that branch.

On the franchise model, for each branch opened the bank will receive a certain amount of capital equivalent to the initial fee paid by the franchisee for the right of using the bank brand name and business format. This capital is free to be used directly on the banking business, giving the bank a complete flexibility to invest the resources wherever it is more beneficial to the bank, either in financial or strategic terms.

It is important to emphasize that I am not arguing that the rates of return are automatically higher in the franchise system than in the traditional model, just because of the negative initial investment. The financial comparison in terms of rate of return of the project will depend on the each specific case: the terms of the contract, the set-up costs, the value of the brand name, and above all, the cost of
capital used on the analysis. The financial viability in franchising a branch must be the subject of careful analysis before the definition of the terms of the contract to be used on the franchise system.

ентр Improvement on the bank’s financial controls due to the exigencies created by the franchise model.

We saw on the previous chapter that the exigencies of financial controls on the franchise system are much tighter than on the traditional model. These tighter exigencies are linked to the fact that what was “managerial information” on the traditional model, becomes real cash-flow at a franchised branch. Thus, there is a much stronger incentive for the bank to build much more precise financial control systems to control the now “real” cash-flow between the bank and the franchised branches. As it would not make any sense to build a system to control just the franchised branches, the whole bank benefits from the new system. Indeed, this improvement on the bank’s financial control is more a (good) side effect than properly an intentional direct benefit of the franchise system.

It could be arguable that any bank working on the traditional model could have control systems as good as the banks operating on the franchise system, given that this is just a question of willingness to build and use the systems. However, the main flaw on this argument is to forget that the incentives to build precise internal control systems are much smaller than to build external ones. On the franchise model, most of the control systems that were previously internal (low priority) become external (high priority).

ентр Economies of scale due to the acceleration on the growth of the bank.

On the franchise system, the potential of growth becomes enormously higher than on the traditional model, because of the elimination of the main restriction to grow for banks: capital to invest on new branches. The only restriction will be the capacity to gain market share. As a result, it is likely that a bank will grow faster with the
franchise system, at least in number of branches, than with the traditional system. As it was discussed on the Chapter One, the larger the number of branches, the more economies of scale a bank will get due to the higher dilution of the fixed costs.

Considering that economy of scale is one of the main competitive factors on the retail segment of commercial banking, any gain on this factor will affect directly the competitive advantage of the bank.

Strategic / Marketing

⇒ Increase local responsiveness without compromising the global gains with scale.

The increase on the local responsiveness will be the direct result of the closeness of the entrepreneur (franchisee) to the bank’s final client. Even though the franchisee’s actions may not be completely autonomous due to contractual rules on the franchise system, there will be innumerous ways for the franchisee to mach the products she is selling on the branch to the customers needs.

The first local adjustment a franchisee can do to satisfy local demand is to change the “prices” of the products sold at the branch level accordingly to her strategy on developing the local market. Given that only the “cost” of the products is fixed by the bank (for example, the internal cost of money), in varying his profit margin the franchisee can manage to capture more market share or more profitability, depending on her strategy.

Another aspect that will make the bank to be more responsive to local needs is the pressure the franchisees will exert on the bank to get better products and prices in order to be more competitive. On a franchise scheme, the bank’s client is not really the final customer, but the franchisee, which has much more power to negotiate with the bank than an individual would have. If we consider that the franchisees’ demands will be correlated to the final customers’ demands, the overall responsiveness of the bank to the market needs will certainly improve.
Finally, the franchisee can tune the client’s perceived quality of the bank through the adjustment of the branch’s factor of quality: environment and staff. For example, if the local clientele is concentrated on a more sophisticated segment of market, the franchisee may prefer to maintain a more educated staff (paying more for that), offer additional amenities at the branch (free coffee, VIP room), but charging a higher premium for the products and services. On the other hand, if the clientele is less sophisticated, the branch could offer a more “basic” pack, and charging a lower premium for that. The fact that the franchisee is closer to the branch’s customers will permit a better adjustment than it would be possible if a central organ had to do that, as it happens on the traditional model.

- **The bank can focus more on the banking core business (money management, financial services, credit management, risk management, marketing and IT).**
  
The skills needed to start and manage a branch are more similar to those needed on opening a car dealership shop, a gas station, or a fast food restaurant, than to those needed to operate a bank. With this divergence on the skills required to operate a vertically integrated supply chain, a traditionally managed bank has to divert too much of its limited energy from the banking core business to manage the owned network of “retail shops”. On the franchise system, the skills required to operate the retail chain (the branches) will be the responsibility of the franchisees, while the bank can focus its skills on creating better products, managing money, evaluating credit, strengthening the bank brand name, or simply, “doing banking”.

- **Improvement of the distribution channel (better feedback, better quality of sales).**
  
  This benefit is similar to the increase of the local responsiveness, but with emphasis more on marketing than on strategy. On the traditional model, the points of sale (branches) are normally too far (geographically and psychologically) from the decision center, a natural consequence of a large and spread network of branches. The
pervasive result of this distance is the difficulty in making this network to perform efficiently all the expected functions of a distribution channel. With the franchise model, that distance between the decision and the action will be diminished by the presence of the franchisee.

On the sales function, the franchisee will act as a local decision maker when adjusting the sales factors (price, place, promotion) to the local demand. Moreover, he will be probably much more sensitive than the traditional manager to propositions from the marketing division that may improve the performance of his business. The main motivational factor for a franchisee is to develop his franchise, and so, he will welcome every good idea and resist to bad ideas from wherever it comes.

The feedback function is probably the aspect of the distribution channel will be more affected by the franchise system. A franchised branch is essentially a firm buying products and services from the bank in order to resell them to the final consumer. The expected behavior of the franchisees is that of an extremely demanding corporate customer, whose buyer is the owner personally. This demanding behavior will be translated on a strong pressure exerted over the bank for better products and prices. With proper interpretation, this pressure may be an extremely rich source of feedback from the market, given that what the franchisee is demanding is a direct reflex of the demands from his customer, that is, the final market.

- **Better positioning to grow faster, due to lower capital investment, distribution of responsibilities, and focus on the core business.**

This benefit is indeed the effect of all the other described benefits on the strategic positioning of the bank. In summary, what the franchise system will bring to the bank is the alleviation or elimination of some of the most important constraints to the growth: capital and managerial competence. The release of capital from the network of branches will make possible the leverage of investment on core business related projects. With the managerial capability brought by the franchisees to take care of the
retail part of the bank (the network of branches), the bank can focus on developing (or creating) capabilities more directly related to the banking business. Finally, with most of the scarce resources invested in strengthening the bank nucleus, the bank will be much better positioned for a faster and more solid growth path.

Corporate Culture

⇒ Nurture entrepreneurial culture: highly demanding franchisees will force the bank to respond more actively and so, becoming more competitive.

The introduction of the highly demanding “outsider” (the franchisee) on the bank structure will induce two beneficial reactions from the “establishment”. The supply side, represented by the divisions that are responsible for the “production” of services and products to be sold through the branches (marketing, treasury, IT), will have to respond much more aggressively to the necessities originated on the distribution channel. These areas were previously accustomed to deal with internal customers, being often managed as cost centers, but with the franchise system they will have to face real customers and be managed as “profit centers”. The metrics defined for cost and revenue allocation will be the new basis for assessing the performance of the suppliers, which in turn will be obliged to think in reduce costs, increase quality of the “products”, listen to the “customer”, etc.

The demand side of the bank, or the branches that will remain owned by the bank, will have to face a much sharper and direct competition. As the franchisees will sell the same products, and use the same business format and brand name, it will be very easy to compare performances across the network of branches. With an adequate system of reward based on relative performance across the branches, the employees at the bank-owned branches will tend to respond more aggressively, with performances converging to the average (that includes the franchisee performances).
Create a new alternative for career path on the bank: “promote” good people granting the right to buy a franchise.

This is not a mandatory characteristic at the franchise model, but the creation of a new career path will bring two different benefits. The first one is the retention of talents under the bank’s “umbrella”, even with the franchised branch not being really inside the bank. If we consider that the alternative way for that talent would be to work for a competitor, it is much more desirable to keep her working with the goal of strengthening the bank competitiveness at a franchised branch.

Another benefit in creating this new career path is the attraction of new talents to work for the bank at the beginning of their careers, mainly because of the possibility of an entrepreneurial career path at some point of their lives. This would not be really an innovation on the human resource management, given that consulting firms and investment banks have used this factor to attract talents for a long time. The difference is that, instead of buying a share of the whole bank, the person would buy the whole branch.

Challenges faced on the franchise model

The “challenges” discussed in this session are rather a collection of common doubts raised during the process of research and definition of the franchise model. The goal here is to address the potential (and frequently fictitious) problems, trying to either eliminate the doubts related to the system or describe some preventive actions to avoid the problem to become real.

With the franchise system the branches eventually take the “face” of the entrepreneurs (the franchisees) and so, it will be hard to ensure the consistency of the customers’ experience with the bank.

This is a real risk on the franchise system and therefore, it must be the object of careful analysis when designing this system for a bank. On the Third Chapter, the
boundaries defined to the franchisees are general guidelines to minimize this risk. However, there is always a tradeoff between uniformity of services and local responsiveness at the network of branches. The loss on the uniformity caused by the new system is plainly compensated by the advantages of having a better local responsiveness at the franchised branch, as discussed on the section “Benefits of the Franchise System”. Moreover, the differentiation among branches in terms of perceived quality of the services provided are the primary tools available to the franchisees to compete and make her business grow. The role of the bank on this issue is to prevent excesses and to use these differences to incentive the improvement of the whole network.

⇒ There may be fierce competition among branches, either among the franchised branches, or between franchised and owned branches.

This is indeed a healthy challenge in multi-branch organizations because the positive competition among branches will certainly lead to better services offered to the customers, which will eventually reflect on the bank’s competitive positioning. The competition is generated by the new incentive system used on the franchised branches – where profit is the king - and thus, all the efforts will be made by the franchisees to preserve and boost profits. The franchisee will always complain (and exert pressure on the bank) that the owned branches are being favored, for example, on the fees charged by the bank or on better support to the products and services. This behavior is completely sensible considering that the franchisee is fighting for the growth of her business. On the side of the owned branches, the competition may appear because the franchised branches will be the new benchmark in terms of results, given that they will compete with the same tools as the owned branches do. With this, it is expected that the managers on the owned branches start to act competitively against the franchised branches, trying to attract the other’s clients through the offering of advantages to the clients (but preserving the profitability).
There is certainly the risk of destructive competition (cannibalization), with for example, one branch avoiding to provide services to others' customers in order to discourage them to continue to be other branches' clients. At this point is where the bank must act as a mediator, protecting the customers' rights and setting the appropriate penalizations for the involved parties to disincentive that kind of behavior. The pre-condition for the bank to act as a mediator is to have an open channel with the customers, direct and indirect (through the branches), but fundamentally to be highly responsive to any sign of harassment to the clients.

⇒ The franchisee will be the primary point of contact of her customers with the bank. As a consequence, she will have the control over those relationships, a situation that puts the bank in a position of hostage in case of termination of the bank-franchisee relationship.

It is natural that the relationships with customers be controlled by the franchisee because they (the customers) are the most valuable assets of the franchise. As it was discussed of the Third Chapter, a great part of the incentives for the franchisee to invest in building long-term relationships is to add value to his business that will eventually be harvested in the future. Therefore, it is expected that the agent responsible for adding value to the business be the same agent who controls it.

On the other hand, the bank also takes an important role on building the relationships, through either financial or institutional support (splitting the discount on fees, developing brand name and offering good services) and so, the bank should have some degree of control over the relationships. Given that a bank must have full access to the branches' customer database, to perform either the credit analysis or the transactions clearing, this bank does have control over the relationships.

Finally, this "game" of controlling the relationships with the customers is not stable. On one hand, the bank could use its full access to the branch's customer database to "steal" the most valuable from the franchisee, and on the other hand the franchisee
could take all the customers away with her in case of termination of the relationship with the bank. As this is a potentially explosive situation, contractual clauses must carefully address the cases of misuses (by both parties) of the control over relationships in order to prevent them to happen, and ultimately to avoid long and harmful legal trials.

⇒ It is hard to motivate highly entrepreneurial persons as the franchisees, given the necessary restrictive rules limiting their entrepreneurial actions.

This is a challenge faced not just by franchised banks but by any franchised retail firm. The restrictions represented by the operational rules are not the only factor affecting the franchisees’ motivation. On the retail industry, most of the growth of a firm is due to the expansion on the number of points of sale, and not to the expansion of the branches individually (number of clients on a given branch, or volume per client). This means that the potential of growth for a branch is quite limited, a crucial restriction when we think in motivating entrepreneurs eager to grow their businesses.

The traditional solution used on the franchise industry for this problem is to open the possibility for a franchisee to own more than one branch, depending on her performance with the current branches. This solution, besides addressing effectively the motivation problem also helps in another issue: the difficulty in getting good franchisees. It is much safer to grant a franchise to an already proven person than to a person that has not shown his potential yet.

Nevertheless the quality of this solution, it must be used consciously, with the establishment of an upper limit on the number of branches granted to a franchisee. The first problem in a franchisee having a large number of branches under his management is that he would have too much bargaining power to negotiate the terms of the contracts with the bank, which could put in risk even the bank’s market positioning. An extreme example of this phenomenon happened with Coca-Cola in Venezuela, when the only franchisee responsible for all the network of bottlers
decided to move to Pepsi-Cola. It was very hard for Coca-Cola to recover from this problem there. In addition, the same management problems faced by a bank with a large network of branches - discussed on the Chapter One - would be faced by a franchisee owning a large number of branches.

⇒ The franchisees, as partners and not employees, will exert high and constant pressure on the bank for better prices, rates, services, and products. Not to mention the potential resistance in accepting new products, marketing campaign, etc. when they (the franchisees) do not see potential success on the innovations.

This challenge is indeed one of the most important elements in franchising that leads to the corporate improvement. The shift on the management paradigm from the central imposition to negotiation of ideas is the healthiest aspect on the franchised model. As true customers of the bank’s products and services, the franchisees will demand the best for their business, which ultimately must be for the benefit of the bank if the incentives are well aligned.

However, there are some pre-conditions for this challenge to become a real benefit, and ultimately for the success of the franchise system. The first is the alignment of incentives of the franchisees with the bank strategy, which must be subject of careful analysis and design when defining the terms of the franchise model for a specific bank. The second important factor to extract most benefits from the active role of the franchisees is to nurture a culture of openness and flexibility on the management of the central divisions (treasury, credit, marketing), in order to be highly responsive to the franchisees’ demands, hopefully reflecting the customers’ demands.
The credit concession on the franchise system is a "nobody's land", where the bank is responsible for the credit analysis and funding, but it is the franchisee who ultimately decides to whom concede credit. In case of default, who should pay the bill?

This is a real and important challenge, but it is not exclusive to the franchise model. This challenge is badly solved on the traditional model, in which the bank pays the whole bill in case of defaults, and the account manager gets the bonus in case of performing loans. This dynamics generates an important and dangerous agency problem: the branches have all the incentives to give credit (good or bad) because this would increase the volumes, and consequently the potential bonus. In case of non-performing loans, the bonus generally are is not affected negatively.

On the franchise model, because of the separation of the agents on credit concession, this challenge must necessarily be addressed. It is essential to align the incentives of the branches and the bank's in order to get the whole group working toward the common goal: to concede as much GOOD credit as possible. The most important element on this alignment of incentives is a well designed system of cost and revenue allocation, in which rewards and penalizations are proportional to the decision power on the process of conceding credit, as it was described on the Chapter Three.

It is not clear how much the bank should charge for some internal services (IT, for example), and so, it could be giving money away to the franchisees.

Similarly to the credit concession problem, this is a hidden problem on the traditional model, and not a specific problem on the franchise model. In a really well managed bank, it would be necessary that all the costs and revenues be allocated correctly to the agents. This would permit a better management of efforts in developing a balanced network of branches, while improving the efficiency of the internal suppliers (treasury, IT, marketing, etc).
On the franchise system, as a third party (the franchisee) will be using the bank’s resources, it is necessary to establish prices for every single service provided to the branches. Now, it is not only managerial information involved; it is real money. It is not possible anymore to hide the problem, a fact that is extremely healthy to the bank as a whole. With the necessity of defining an effective system of cost and revenue allocation for the franchised branches, it will be possible to manage better the bank-owned branches, and also the central divisions. Therefore, this is another of those challenges that, when properly faced, brings more benefits than risks to the firm.

⇒ As a separate firm from the bank, with independent accounting system and specific economic factors affecting its performance, a franchised branch could even go bankrupt, a fact that would be prejudicial to the bank’s image.

This is another challenge not addressed on the traditional model, but that can’t be ignored on the franchise system. If a branch (franchised or not) is not economically viable, it is better to re-think either its existence or its management. The fact that a franchised branch has a separate accounting system and so, can have bad performance or even go bankrupt, only turns explicit the problems faced by the branch. Naturally, with the problem (and hopefully its causes) made clear, it is much more sensible for the bank and the franchisee to remedy it before the branch goes bankrupt. Anyway, the solution to this kind of problem passes first by the detection stage, which may sometimes be painful. Anyway, even with the potential risks of damages to the bank’s image in the extreme case of bankruptcy, it much healthier to show the problems on the branches when they appear.

Even with the healthiness of the transparency in showing the problems on franchised branches, the bank must take some actions to make the process smoother in case of problems. The first one is very direct and objective: the establishment, on the franchise contract, of the procedures in case of financial problems on the branch. The establishment of rights and duties explicitly will avoid possible legal contends against
the franchisee, which could be really harmful to the bank. Another action, which is quite subjective, is to establish a contingency plan in case of problems, in order to avoid harms to the bank’s image. Either the clients could be affected because of bad services during the crisis period, or bad publicity could be generated by the problems with an institution (the franchise) that carries the bank’s flag. This last action will be necessary just in the extreme cases in which the problems can’t be settled smoothly before they become too serious and public.

⇒ As a franchisee will constantly deal with others’ money (bank’s or clients’), there may be cases of corruption at the branches, causing not only financial losses to the bank but also image damages in case of problems with clients’ money.

This is another case of an existing problem on the traditional model, badly addressed in a reactive form. The usual way to deal with this issue on the traditional model is simply to fire the involved people, and try to recover the losses with the minimum publicity possible. Frequently banks avoid going to the court against corrupt employees to avoid bad publicity, turning the problem much harder to deal with.

With the inherent better control necessary on the franchised system, the problem of corruption at branches will be naturally minimized. In addition, a franchisee has less incentives in being corrupt than a regular branch manager for a simple reason: the corrupt employee loses only her job in case of being discovered. The franchisee may also lose her capital, besides losing her job (after all, she works at the branch). Finally, even with the lower probability of corruption on the franchise system, it is crucial that appropriate penalties in case of corruption be stated on the franchise contract.
Considering that the bank guarantees the franchisee’s liabilities with the customers (deposits, investments, etc), the franchise system faces a serious problem of moral hazard.

The franchisee has less incentive to misbehave than a traditional branch manager does, because the latter has only his job and the former has his job and mainly capital at stake. It could be argued that the bank has more control over the branch manager than it has over the franchisee, but this is only partially correct. On the franchise model proposed, the franchisees’ autonomy in taking hazardous actions is highly restrained by a strict control of credit concession and credit risk exposure by the franchisee. Besides the specific controls on credit, the contractual boundaries mentioned on the Third Chapter will serve as a kind of trail to guide the franchisee actions. The strict controls present on the franchise system are still rare on the traditionally managed banks, and therefore we could say that the franchisees are even more controlled than the branch managers. Consequently, the moral hazard problem not only is not an exclusive problem of the franchise system but also it is less likely to happen with franchisees than with branch managers.

Actions taken by the franchisee may affect negatively the bank’s brand name and image.

This is the main challenge in franchising the branches of firms like banks, in which image and reliability are crucial elements on the competitiveness of the firm. Because of the criticality of this issue, the boundaries for the franchisees must be precisely defined on the contract. Look on the Chapter Three for more details about the definition of boundaries for the franchisee actions.

Another potential problem with the franchised firms is the lack of uniformity on the network of branches, in terms of quality of services. Given the entrepreneurial nature of the franchise, it is likely that some differences appear along the time, as a result of the individual efforts from the franchisees in developing their business. One possible
attitude from the bank toward this fact is, instead of depriving the initiatives of franchisees trying new ideas, implement a program whose main goal is to evaluate those initiatives, and extend the good ideas to the rest of the network. At McDonald’s, a large proportion of the basic menu is the result of ideas tried by franchisees and extended to the whole network. It is amazing the fact that Big Mac - McDonald’s most successful product – is indeed a creation of a franchisee. The role of the bank on this issue must be that of a judge of ideas, extending the good ones to the whole network, and discontinuing the use of the “bad” ideas (bad in the sense that they are not coherent with the bank strategic positioning).

⇒ It is hard to find good franchisees that will be able to strengthen the bank positioning on the market.

Yes, it is very hard to find good franchisees, mainly with the growth of the number of franchised firms on the retail segment. However, it is even harder to find and specially attract good employees to work at the branches of a commercial bank. There are two schemes of franchisee management that can help to alleviate the problem of finding good franchisees and also address other important challenges.

The first recommended scheme is to open the possibility for a franchisee to own more than one branch. The obvious benefit is that, instead of being exposed to the risk of selecting a bad franchisee, the bank will use a market proven franchisee. Additionally, as it was commented previously, this may be used as a tool to motivate the franchisees. The only drawback on this strategy is that it depends on the existence of a number of good franchisees at the bank structure to be effectively applied. Moreover, as it was mentioned before, the number of branches a single franchisee may manage must be limited in order to avoid problems with “overgrown” franchisees, a fact that limits the potential of use of this scheme.

Another good source of potential franchisees is bank’s staff. With this strategy, an additional career path would be created on the bank: a good employee could either go
to management or be granted the right to franchise a branch. Besides the benefit of being a rich source of good franchisees, this strategy would have as a good side effect the improvement on the capacity of a commercial bank to attract new talents. The traditional career at commercial banks is not very attractive due to the excessive stability on the industry, but the possibility of becoming an entrepreneur at some point of the career would make the commercial banks much more attractive.

⇒ Legal issues

Commercial banking is traditionally a highly regulated market all around the world. The strictness of the regulations varies from country to country, but generically speaking, the rules for banks are generally stricter than for the other segments of the market. The nature of the regulations may be commercial, with laws overprotecting the rights of clients, or financial, with the central banks establishing maximum leverage ratios, risk to capital, and other ratios.

Depending on the specific country, there may be specific restrictions with the franchise system because of the split of one financial institution (the whole bank) in a group of small independent institutions (the franchised branches) linked to the bank through a commercial contract. Therefore, it is crucial that the local legal issues be carefully considered during the process of implementing the franchise system, from the decision to start the project to the definition of the legal nature of the franchised branch (commercial institution, financial institution, etc).

⇒ The exchange of strategic information between the bank and the franchisee is very intense, and so, there is the risk of leaking confidential information to the competitors.

The exchange of confidential information is a two-way process on the franchise system. The bank will supply the franchisees with important financial and commercial information such as cost of money, fees charged for services, and marketing strategy. The franchisees will have to open their client portfolios to the
bank for the credit risk management, for example. Even though this is more an ethical than a legal issue, considering its delicate nature, it must be carefully addressed on the contracts, and constantly reinforced along the period of the relationship. It is important to make clear that this is not an exclusive problem with the franchise system; it already exists in the traditional model, in which the relationship bank-employee is even closer than that of bank-franchisee. In the franchised model it just becomes an issue because of the legal separation of the entities (bank and franchisees).
5. Next Steps

On this paper I made quite broad propositions about alternative models for distribution channels, and a detailed analysis of the franchise system for banks, which was still a general proposition of a model. Actually, the goal of this document was not to present a detailed implementation plan of the franchise system on banks, but rather to propose some useful alternatives in terms of distribution channel, and then, to define a framework to be used when implementing the franchise model in banks. As it would be expected from a framework, the issues discussed here are far from being enough to permit an immediate implementation of that model. Most of the implementation details will depend on the specific market where the bank is operating, and on the specific characteristics of the bank such as corporate culture and strategy. Further specific studies are necessary in order to turn the model operational.

To complement the proposed framework for implementing franchising in commercial banks, on this last chapter I will firstly discuss the most recommended configuration for the network of branches (franchised x owned). Afterwards I will identify a list of minimum steps to be taken when implementing the franchise model in a bank, which can be used as a basis for the actual plan of action on that project.

**Recommended configuration for the network of branches**

The first question that comes to mind when thinking on franchising a retail firm is “should I franchise the whole network or should I continue to own the branches?” On this paper we described all the benefits in adopting the franchise model, but we can’t forget that the traditional model also has an extensive list of benefits, and so, this doubt is perfectly reasonable. Because of the complementarity of the collections of benefits with the traditional and franchise models, I propose a configuration that Harvard’s Professor Jeffrey L. Bradach calls the “plural form”, which is a mix of franchised and owned
branches. This definition of plural form is restricted to the notion of who manages the branches – franchisee or bank. I will go further on that definition and propose the “multi plural form” - which contains also the notion of breadth of the distribution channel - as the best alternative for banks. On the multi-plural form, the distribution channel in banks is a mix of franchised and owned full branches, lean branches and banking mall, plus the virtual bank fully controlled by the bank.

The greatest advantages in adopting the multi-plural form, besides the specific collection of benefits in each component, are:

\(\Rightarrow\) **Mutual benchmark of the branches: franchised branches will serve as reference to the owned branches, and vice-versa.**

We saw on the Chapter Four that the insertion of the franchisees on the structure of branches would be beneficial because the branches managed by highly entrepreneurial elements would serve as benchmarks for the traditionally managed branches. However, in keeping part of the branches under its management, the bank can also benchmark the franchised branches, being able to control all the variables that influence the performance of its own branches. If alternatively the bank franchised all the branches, those variables would be exclusively under the control of franchisees, making it difficult for the bank to evaluate accurately the real factors affecting the performance of branches.

\(\Rightarrow\) **Owned branches will also serve as pilots, and learning sites for the bank.**

As it was commented before, on the franchise system every single new idea proposed by the bank will have to be “sold” to the franchisees in terms of viability and potential profitability. Considering this characteristic, with the whole network franchised, the process of innovation at the bank would be jeopardized because of the difficulty in having new ideas accepted for testing. With part of the branches under its control, the bank can use them as testing sites for new ideas.
Moreover, and maybe more importantly, we can't forget that the branch takes a crucial role on the supply chain of the commercial banks, and so, can't be simply given up by the bank to the franchisees. It is important to keep part of them under control as a way to preserve and boost valuable knowledge related to the supply chain.

⇒ The increase on the breadth of the distribution channel through the plurality of models used will boost the capacity to be competitive in diverse segments of market.

The diversification represented by the different kinds of models used (full branches, lean branches, etc.) will give the bank a much greater flexibility to use the suitable channel to the specific segment of market. This characteristic represents a huge competitive advantage due to the possibility to compete effectively in various segments of market, seizing the higher profitability of the more sophisticated markets, while improving the gains of the scale with the increase on the volumes negotiated.

Minimum steps on the implementation of franchising in banks

⇒ Evaluation of the legal viability of the franchise system, given the local regulations of banks.

This is the first step to be taken because in some locations the regulations for banks may be so strict that the franchise system is not viable, legally or financially. Case the legislation does not permit the legal separation of the branches from the bank, as an independent firm, the franchise system is legally not viable. There are other cases, however, in which the law does not explicitly states that prohibition, but turns any possible solution so complex that it would not be viable to implement the franchise model. In any case, the pre-requisite for this project is to evaluate its viability, given the local legal restrictions.
Top management decision to adopt franchising at the bank.
As in any strategic projects, the franchising of branches must have the explicit support from the bank’s top management. As we could see on the description of the model, the success of the franchise model will depend highly on the preparation of the bank’s structure and culture for the new system. This process of preparation may cause radical changes on the paradigms for the whole structure, and so, the resistance to the changes might be very intense. Without the support from the top management, the whole project may become unfeasible, or fated to the failure.

Preparation of the bank for the franchise system.
We saw on the Third Chapter that there is a set of minimum requirements for a bank to be even “eligible” to use the franchise system. We also saw that, to meet those requirements, a bank may have to make deep changes on its structure, a process that may last long and require substantial investments. It is important to remember that the necessary changes are not the product of the franchise system per se, but indeed are the reflex of the status of the bank in terms of quality of management. None of the requirements is specific to the franchise system, but are rather a compilation of the best practices in banking. A more appropriate name for this process would be “cleaning the bank”, without which the franchise system will bring more problems than there would be in staying in the traditional model.

Learn with the successful and unsuccessful cases of franchising (McDonald’s, Subway, etc.).
The team responsible for the franchising project must have studied carefully the most important cases of success and failures on the franchising industry before starting the specific project for the bank. The challenges faced on the implementation of the franchise system in any industry are quite universal and therefore, it is sensible to enjoy others’ experience to leverage the project’s probability of success, making the necessary adaptations to the bank business model.
Pack the product to be franchised (business format, products, services).
The expression “pack the product to be franchised” means to establish exactly what the bank will be franchising. Generically speaking, there are two types of franchise: product franchising and business format franchising. On the product franchising, the franchisee buys the right for commercializing a product, but not the business format, that is, the style she will manage the store. Automotive dealership is a typical example of this type of franchising. On the business format franchising, the franchisee buys not only the right to sell the products, but also the business format used on the store.

On the case of banks, the business format franchising will be used. The specific issue with banks is that the products are frequently too intimately mixed with the business format to be possible to identify what is product and what is business format. Nevertheless, a perfect understanding of the pack being franchised is crucial on the financial evaluation of the franchise (pricing of the franchise fees). That’s why the step of packing the product to be franchised is specially important when franchising branches at commercial banks.

Create an independent structure to manage the franchise system at the bank.
The responsibilities of this division will range from the definition of the franchise contract to the selection of the franchisees. It is important that this division be independent from the existent structure because of the different nature of this business (different players, different styles of relationships, etc). Even though it is tempting to link this structure to the marketing division because it will deal with distribution channel, it’s important to emphasize the strategic relevance of this structure for the bank, in order to capture all the potential benefits of the franchise system.
Start with a pilot, franchising a new site, to be developed completely by a franchisee.

The rational in starting the implementation with a new site is that this is a much more complete case than starting with an existent site. The collection of challenges to be faced and consequently the test of the new system will be much more comprehensive and realistic.

Conclusion

There is a long way from this point to the successful implementation of the franchise model in the commercial banks. The obstacles in implementing such a system in banks are not related to the complexity or any other specific characteristic of the franchise model. These difficulties arise from the fact that this system exposes some of the bank’s chronic structural deficiencies, which may have been long hidden by the traditional system.

However difficult and painful may be the process of implementing the franchise system at a bank, this is an absolutely worthwhile project to try, not only because of its inherent benefits of the system but also due to the "side effects" of the implementation process per se. The inherent benefits in adopting the franchise system were extensively described on the Fourth Chapter, but I want to highlight those related to the changes caused on the culture of the bank. These changes are particularly important for commercial banks, traditionally recognized for their low profile culture of passiveness and conservatism.

In addition to the direct benefits of the franchise system, there are the (good) side effects caused by the process of preparation of the bank’s structure to make viable the implementation of the franchise model. The fact that some of the structural chronic problems must be addressed (and solved) to respond to the exigencies of the franchise is one the greatest virtues of the franchise system, resulting in a big leap of quality on the management of the business.
Finally, the globalization of the world economy, the generalized deregulation on
commercial banking, and the growth of e-business are rapidly changing the economical
environment in which the commercial banks operate. The barriers to entry on this
segment of market are becoming increasingly smaller, attracting aggressive new players
to the game. The current big players who want to continue competitive on the commercial
banking segment must quickly react to be prepared to the new economy. The franchise
model fits perfectly to this urgency to react fast because it has the potential to cause an
enormous boost on the growth due to the elimination of the capital constraints to open
new branches, but mainly due to the “shaking” on the structure and culture of the bank.
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