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## Generic Strategies and Financial Performance Persistence in the Banking Sector in Indonesia

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### ABSTRACT

*This study investigated the association between bank strategic positioning and performance. The central issue in the management literature has been to identify the sources of competitive advantage that allow firms to achieve and retain persistent superior performance over their competitors. Either cost leadership or differentiation strategy could build a bank's competitive advantage. Hypothetically, a cost leadership strategy creates competitive advantages through operational efficiency, hence, the superior performance of banks which adopt such strategies logically to be more persistent over time compared to banks with a differentiation strategy. This study conducted an empirical investigation of the hypothesis using a sample of 216 firm-years over the period 2009-2013. Constructs from audited financial-level archival data were developed to capture a bank's strategic positioning. These constructs were then used in empirical models that explore the persistence of bank performance. Using confirmatory factor analysis, the empirical results indicate that although both cost leadership and differentiation strategies have positive effects on contemporaneous performance, only a cost leadership strategy allows a bank to have persistent superior performance in the following period.*

**Keywords:** *Generic strategy, efficiency, differentiation, persistence performance*

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## INTRODUCTION

In the last two decades, management accounting practices and research have evolved to include a more strategic approach. These developments have prompted several studies in management accounting, which focus on the interaction between managerial accounting practices and organization strategies. Some literature has examined the relationship between companies' strategic choices and accounting systems design (Ittner & Larcker, 2001; Banker, Mashruwala, & Tripathy, 2014). Barriers to undertake further investigation is likely due to a lack of development of a comprehensive proxy for corporate strategy. The focus of this study is to follow Banker et al. (2014) who developed measurement strategies adopted by firms. Furthermore, this investigation intends to see which bank's financial performance remains persistent.

This research is motivated by limited studies that examine the association of corporate strategy and financial performance, especially in the financial services industry. Also, some previous studies still show mixed results (Chan & Wong, 1999; Powers & Hahn, 2004). Research needs to be done to test this relationship because service firms have different characteristics to non-service firms. Most researchers have examined the sources of competitive advantage enabling manufacturing firms to maintain superior economic performance. According to Porter (1980), the firm with a competitive advantage based on cost leadership or a differentiation strategy can outperform its competitor. Porter (1996; 2001) argues that technological innovations enable operational improvements and increases cost efficiency.

Barney (1991) and Porter (1996) conclude that if the competitive advantage is easily imitated by competitors, these benefits will disappear over time. When competitors perform a similar activity to or better than the firm, it will jeopardize the sustainability of the firm's performance. The firm needs to diversify the activities undertaken and services delivered to maintain financial performance (Banker, Mashruwala & Tripathy, 2014). However, Miller (1992) states that the real cost leadership (the strategy that does not combine with a differentiation strategy) would be useful if the customers are sensitive to price, and the opportunity to get the cost benefits is clear. This concept applies to the banking industry due to the bank's customers being very price sensitive to the loans and deposits rates.

Thus, banks that adopt a cost leadership strategy could generate better performance regarding benefits for customers compared to competitors who pursue other generic types of strategies or choose to be in the middle (Powers & Hahn, 2004).

Considering the proposition regarding the association between strategic position and banks' performance, this study investigates whether banks with a low-cost strategy are more likely to have financial performance over time than banks with a differentiation strategy?

Banker et al., (2014) developed an empirical model using accounting data of non-regulated firm to address that research question. This study modifies the research method further to suit the banking industry by combining the empirical model of Banker et al., (2014) and the strategy scale of Powers & Hahn (2004) to determine operational strategies persistence level of financial performance.

This study used the financial data available on the website of Bank Indonesia from 2009 through 2013. Samples were taken by the purposive sampling method to obtain a final sample of 55 banks, resulting in the sum of 216 firm-year observations. Validity and reliability tests were conducted to examine whether the variable weight of the strategy dimension is consistent with the theoretical argument as suggested by the result of the Confirmatory Factor Analysis (CFA). The estimation method of year-over-year of Fama-Macbeth (1973) was used to test the persistence of financial performance as the result of the implementation of low cost and differentiation strategies. The test result indicates that low-cost strategy enables banks to have higher persistent of financial performance compared to a differentiation strategy. The empirical robustness test shows consistent results with the primary analysis.

Having reviewed the previous studies regarding strategic-position and financial performance, this study contributes in several ways. First, this study modifies the strategy measurement used in research of Banker et al. (2014) to suit and assess the persistence of financial performance in a specific industry - banking. Second, this study adds to the management accounting literature related to firm strategy and performance, and fill some of the gaps with a focus on the banking industry in Indonesia. Finally, compared to previous studies which used a questionnaire to capture perception regarding

the association between strategy and performance, this study modified scale measurements (which are claimed to be more objective compared to a questionnaire) as a research instrument.

The remainder of the paper is organized as follows. Section 2 provides a relevant literature review to build the theoretical framework and develop the hypotheses, followed by Section 3 which includes the research method. Section 4 reports the empirical results. Finally, Section 5 presents the conclusion of this study.

## **THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT**

### **Porter's Generic Strategies**

Porter (1980) introduces three generic strategies that can be adopted by firms to gain a competitive advantage, namely cost leadership, differentiation, and focus. Accordingly, firms with a competitive advantage can outperform others. Cost leadership strategies are emphasizing on minimizing the cost mainly through operational efficiency to gain competitive advantage. Low-cost strategies usually require a high level of expertise to design efficient products and need substantial capital investments. On the other hand, firms with a differentiation strategy would create some unique products so that consumers are willing to pay a premium price. The differentiation strategy emphasizes product development and continuous innovation, and conducts aggressive marketing and sales activities. For this type of strategy, the expenditure associated with these activities allows firms to get a premium price compared to their competitors. Consistently, banks that adopt this strategy usually provide interest rates above the market price (Berman et al., 1999). As for the focus strategy, in contrast to the other strategies, it emphasizes on the narrow market segment to compete in the industry. This strategy is based on the premise that the firm will be able to serve narrow strategy targets more effectively and efficiently than competitors that serve a wider target.

## Generic Strategies of Banking

In the banking industry, a key determinant of the success of the differentiation or low-cost strategies depends on whether the bank understands the market structure (Young, 1999). The distribution systems, technology, segmentation, pricing, product development, branding, quality services, and bank relationships are ways of achieving a differentiation strategy (Farrance, 1993; Devlin, 1995). A study with a sample of Indonesia banks conducted by Rustamblin et al. (2013) shows that a differentiation strategy has a stronger association with a bank's performance compared to other strategies (i.e., low-cost strategy, as well as an integrated strategy). On the contrary, Powers & Hahn (2004) argue that banks are hardly getting superior benefits when applying the differentiation strategy. Differentiation strategies may have significant limitations to be applied in the service industry because of the simple and easy to imitate nature of differentiation in financial services, except when the target market is very sophisticated and has complete knowledge, which is highly unlikely.

## Financial Performance Persistent

Performance persistence is an indicator of the future performance generated by the firm repeatedly over the long term. Profit performance persistence is the relationship between the current and future profit performance (Sloan, 1996; Freeman, Ohlson, & Penman, 1982). They define profit as operating profit divided by total assets. Francis et al. (2004) measure the performance persistence from the slope coefficient of the regression results in the current performance to lagged performance. Performance is defined as performance from ordinary activities (net income before extraordinary items).

## Hypothesis Development

Firms should maintain their unique position (differentiation) or low cost to reach superior performance. The difficulty of the differentiation strategy lies in the inability of companies to withstand competitors from imitating or even increase sources that have a competitive advantage. Also, most of the competitors apply a systematic method to obtain information and new techniques which is spread rapidly across the industry (Barney, 1986). The technological advances in recent decades have allowed the

rapid diffusion of information and enables companies to duplicate the new business processes or products quickly. As a result, many firms fail and are incapable of taking advantage of adopting innovative tools and techniques to improve productivity, quality, efficiency, and sustained profitability (Porter, 2001).

In the service industry such as banking, the differentiation strategy may be complicated to implement given the services that are readily replicable (Devlin & Ernew, 1997). The possibility to successfully adopt a differentiation strategy is feasible only when the target market has high knowledge and sophistication, which is highly unlikely. Also, the banking industry is perceived as having an important role in the national economy, hence, is highly regulated by the State. Accordingly, innovation or differentiation is limited due to the rigidity of rules and regulation applied to banking and set by regulators (central bank or financial services authority). Based on these arguments, the hypothesis proposed in this study are as follows:

- H1: Banks that implement low-cost strategies will have a higher performance compared to banks that implement a differentiation strategy.
- H2: Banks that implement low-cost strategies are more likely to have persistent financial performance over time compared to banks that implement a differentiation strategy.

*Figure 1* describes the research framework of association between the generic strategies and bank performance.



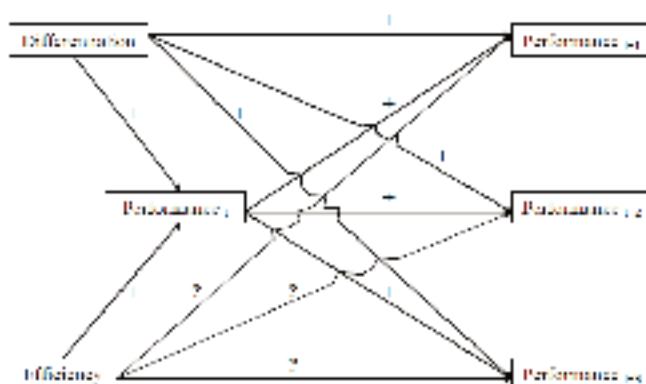


Figure 1: Research Framework: The Association between Generic Strategy and Bank Performance

## RESEARCH METHODS

### Sample Selection and Data Sources

The data source was the financial data available on the website of Bank Indonesia ([www.bi.go.id/id/publikasi](http://www.bi.go.id/id/publikasi)) which covers income statements and balance sheets for the period 2009-2013. The purposive sampling method provided a final sample of 55 banks, resulting in 216 firm-year observations. This study concentrated on the banking industry to minimize cross-industry variations that can affect performance persistence. Observations before 2009 were removed from the sample to avoid the possible impact of the global crisis 2007-2008. This study also removed samples with profit before extraordinary items have negatively value.

### Model Specifications

This study developed a model based of Banker et al., (2014); and determined elements of a generic strategy according to Powers and Hahn (2004). This study used return on assets (ROA) as a measure of bank performance.

$$ROA_{it} = \alpha_0 + \alpha_1 \text{Differentiation}_{it} + \alpha_2 \text{Efficiency}_{it} + \Gamma_{it} \quad (1)$$

Equation 1 describes the effect of the strategy on bank performance, in which ROA it is a return on assets of firm *i* in year *t*. ROA is profit before extraordinary items divided by average total assets. This study assumes that the ROA stated as performance persistence, if regression generates a positive financial performance and is significant over time. Differentiation and Efficiency refer to the type of strategy followed by the bank in period *t*. To test the impact of the strategy on the bank's future performance, we estimate the following equation:

$$ROA_{ij} = \beta_0 + \beta_1 ROA_{it} + \beta_2 \text{Differentiation}_{it} + \beta_3 \text{Efficiency}_{it} + \Gamma_{it} \quad (2)$$

Equation 2 to test the bank's ability to maintain ROA impending based strategy followed in period *t*, ROA<sub>*i*, *t*+*j*</sub> refers to a return on assets of the firm *i* in period *t*+1, *t*+2 and *t*+3. In evaluating the impact of strategy variables on the future performance, this study controls the bank's performance in period *t* by entering ROA<sub>*t*</sub>. ROA<sub>*t*</sub> coefficient explains the performance persistence from period *t* to period *t*+*j*. This study expects the coefficient of the low-cost strategy in period *t*+1, *t*+2 and *t*+3 is positive and greater than the differentiation strategy. For banks that use a differentiation strategy, the positive effects are expected to disappear over time.

## Techniques of Data Analysis

This study adjusted the cluster analysis of the Powers & Hahn (2004) study to modify the strategies measurement using the variables as presented in Table 1.

**Table 1: Variables Used to Construct Strategy**

Variable	Strategy	Sign
Average Property Plant & Equipment (PPE) / net income	Low-cost	EFF1
Average loans / net income	Low-cost	EFF2
Average salaries expenses / net income	Low-cost	EFF3
Average promotional expenses / net income	Differentiation	DIFF1
Average interest income / interest expense	Differentiation	DIFF2
Average fee-based income / net income	Differentiation	DIFF3

Description of each low-cost strategy variable is as follows. EFF1 – firms utilize the investment to generate income (David et al., 2002), and investments in PPE to attain the firm's low-cost strategic choice (Gale, 1980; Porter, 1980). Banking could have or reproduce assets such as computer devices to reduce operating costs or improve efficiencies associated with delivery of banking services. EFF2 -- one of the low-cost strategies undertaken by maintaining the capacity and flexibility of loans (Powers & Hahn, 2004). This approach is taken to manage the risks and to take advantage of opportunities such as controlling weight and improving profit margin. EFF3 – a way to pursue low-cost strategy by employing experienced and trained employees (Hambrick, 1984; Kotha & Vadlamani, 1995; Powers & Hahn, 2004).

The following are a description of each of the differentiation strategy variable. DIFF1 -- higher allocation of resources to the promotion and marketing show the effort to build and strengthen the bank's image and products. Innovation in marketing techniques and methods is one of the differentiation strategies in banking (David et al., 2002; Powers & Hahn, 2004; Banker et al., 2014). DIFF2 – differentiation strategy can be done by offering services at a higher price segment (Porter, 1980; Berman et al., 1999; Powers & Hahn, 2004; Banker et al., 2014). Although a bank is a regulated firm, in practice they continue to use the firm's strategy to be more superior than competitors. DIFF3 – this ratio is a proxy of the extensive customer service capability (Powers & Hahn, 2004). Fee-based income (FBI) is an innovative way to help raise revenue in addition to non-bank revenues.

This study calculates the average of the five-year period of bank data from each variable to obtain long-term strategic orientation. Validity and reliability tests were conducted to examine whether variable weight on the dimension of a strategy which is expected as suggested by the theoretical argument is consistent with the result of the CFA. This study estimated Equation 1 and Equation 2 using the estimation method of year-over-year of Fama-Macbeth (1973) to test the persistence of banks economic performance resulting from either a low-cost and differentiation strategies.

## RESULTS

### Testing the Results of Factor Analysis and Descriptive Analysis

Table 2 explains the results of the CFA that indicates two factors (EFF and DIFF) formed by five variables (EFF1, EFF2, EFF3, DIFF2, DIFF3). Factor loading explains the magnitude of the correlation of a variable with EFFICIENCY and DIFFERENTIATION factor. Considering the benchmark for the strength of factor loading suggested by previous studies range from 0.6 (Ghozali, 2006) to ideally 0.7 (Hair et al., 2010). The results suggest that the correlation between EFFICIENCY and EFF1 (0.673), EFF2 (0.846) and; EFF3 (0.749) are quite strong. A similar strong result is also provided for the correlation between DIFFERENTIATION and DIFF2 (0.664) and DIFF3 (0.798). Community (column 4) is the amount of variance (in percentage) indicating the greater value of variable community means more closely related to factors formed. The variable of EFF2 has the highest value (0.717) which means that approximately 71.7% of the EFFICIENT factor can be explained by the EFF2 variable.

**Table 2: Confirmatory Factor Analysis of Strategic Measures**

Variables	Efficiency Factor Loading	Differentiation Factor Loading	Total Community
EFF1	0.673		0.469
EFF2	0.846		0.717
EFF3	0.749		0.562
DIFF2		-0.664	0.582
DIFF3		0.798	0.681
Initial Eigenvalues	38.308	21.914	
Variance Explained	1.915	1.096	
Cronbach Alpha	0.10	0.01	

Note: EFF1 – average PPE / net income, EFF2 – average loans / net income, EFF3 – average salaries expenses / net income, DIFF2 – average interest income / interest expenses, DIFF3 – average fee based income / net income.

The empirical test results of CFA for EFFICIENCY factor show a positive association with EFF1, EFF2, and EFF3. This test indicates that banks that choose a low-cost strategy are characterized by the magnitude of: (i) the ratio of the average PPE / net income; (ii) the ratio of average loans / net income; and (iii) the ratio of average salaries / net income. Accordingly, all three variables can explain a bank's efforts to push the cost savings associated with the low-cost strategy. More precisely are: (i)

having assets (device or facility technology) is excellent to save operating costs; (ii) providing loans in large numbers enables the lowering of lending rates; and (iii) giving a respectable amount of salary or remuneration to get a professional and skilled human resources to boost efficiency.

The results of the CFA test of DIFFERENTIATION factor demonstrate that DIFF2 is negatively correlated, while DIFF3 is positively correlated with the differentiation strategy. Accordingly, a differentiation strategy is characterized by: (i) low ratio of average interest income/interest expense; and (ii) the high ratio of the average FBI/net income. Variable DIFF2 shows the small margin in explaining the bank's strategy of differentiation is presumably due to the significant proportion of income coming from a fee-based income, while the variable DIFF3 is consistent with the predictions of Power & Hahn (2004). The fee-based income (FBI) is high reflecting the unique form of service that is given as an alternative way for banks to earn other income such as technology-based banking services (innovative form) through e-banking or ATM for payment of transportation (plane or train) or other utility bill payments both to customers / non-customers.

Table 3 reports the results of the correlation between variables. There is a positive correlation between the efficiency and differentiation with ROA<sub>t</sub> (0.657 and 0.099), ROA<sub>t+1</sub> (0.497 and 0.103), ROA<sub>t+2</sub> (0.462 and 0.104), and ROA<sub>t+3</sub> (0.439 and 0.092). The correlation results show that coefficient correlation for the low-cost variable has a higher value and stronger statistical significance (p-value less than 1%) compared to a differentiation variable (none of the correlation coefficients has statistical of less than the lowest benchmark of 10%).

**Table 3: Correlation Analysis**

	Efficiency	Differentiation	ROA (t)	ROA (t+1)	ROA (t+2)	ROA (t+3)
Efficiency	1.000					
Differentiation	0.174	1.000				
ROA (t)	0.657***	0.099	1.000			
ROA (t+1)	0.497***	0.103	0.770***	1.000		
ROA (t+2)	0.462***	0.104	0.641***	0.809***	1.000	
ROA (t+3)	0.439***	0.092	0.650***	0.798***	0.829***	1.000

Note:

\*\*\* significant at 1%

\*\* significant at 5%

\* significant at 10%

### Analysis of Performance Persistence (ROA)

The estimation results of equation one is shown in Table 4 to examine the association between the bank's strategy and bank's performance (H1). The results support previous literature (Banker et al., 2014; Chan & Wong, 1999; Power & Hahn, 2004; Rustamblin et al., 2013) that both strategies have a positive impact on financial performance (ROA), with the impact of a low-cost strategy (0.002, Fama-MacBeth t-statistic = 2.25) is higher than the differentiation strategy (0.001, Fama-MacBeth t-statistic = 1.10).

**Table 4: Association between Strategy and Financial Performance (ROA)**

Variable	Prediction Sign	Coefficient (Fama-MacBeth t-stat)
Intercept		0.014***
Efficiency	+	0.002**
Differentiation	+	0.001
Adjusted R <sup>2</sup>		0.074
F-statistic		3.145**

Notes:

\*\*\* significant at 1%.

\*\* significant at 5%.

\* significant at 10%.

Table 5 shows the test results of the two strategies (differentiation and/or efficiency) that causes positive performance persistence (H2). The empirical test of Equation (2) provides the results as expected in which the estimated coefficient for ROA<sub>it</sub> is positive and significant for each year t+1, t+2 and t+3 (0.945; 0.715, and 0.741, with the Fama-MacBeth p\_value, is = 0.00; 0.00; and 0.00). The coefficient for the interaction ROA<sub>it</sub>\*Efficiency<sub>it</sub> is positive and significant only at t+2 (0.096); Fama-Macbeth p\_value = 0.00. As for the other interactions that ROA<sub>it</sub>\*Differentiation<sub>it</sub> none has p\_value within the range of a statistically significant level of below 1% to 10% in every year. When the p\_value is not considered, the comparison between the two coefficients regression shows that the coefficients of ROA<sub>it</sub>\*Efficiency are consistently higher than ROA<sub>it</sub>\*Differentiation across years.

Table 5: Financial Performance Persistency (ROA)

Independent Variable	Prediction Sign	Coeff. (Fama-MacBeth t-stat) ROA <sub>t+1</sub>	Coeff. (Fama-MacBeth t-stat) ROA <sub>t+2</sub>	Coeff. (Fama-MacBeth t-stat) ROA <sub>t+3</sub>
Intercept		0.001	0.004**	0.003
ROA <sub>t</sub>	+	0.945***	0.715***	0.741***
ROA <sub>t</sub> * Efficiency <sub>t</sub>	+	0.060	0.096***	0.075
ROA <sub>t</sub> * Differentiation <sub>t</sub>	+	0.037	0.054	0.066
Adjusted R <sup>2</sup>		0.696	0.582	0.592
F-statistic		28.93***	25.57***	26.14***

Note:

\*\*\* significant at 1%.

\*\* significant at 5%.

\* significant at 10%.

Overall, the hypothesis which stated that low-cost strategy is positively associated with financial performance which is more persistent compared to a differentiation strategy is supported by the data. In other words, through a low-cost strategy, banks could have superior financial performance compared to their competitors with a differentiation strategy.

### Robustness Test

Previous empirical models, have ignored the effect of bank's characteristics on financial performance. Thus, this study conducted a robustness test by adding firm size and growth opportunities variables into the equation. Bank size is measured by the natural logarithm of total assets; while the growth opportunities are measured by the growth of bank interest income. The empirical test (not tabulated) shows consistent results with the primary empirical model (to bust).

## CONCLUSION, IMPLICATION, LIMITATION, FUTURE RESEARCH

This study aimed to examine the association between a bank's generic strategies and financial performance. The focus of the study was on the modification of a construct to capture the strategic position of the bank, and then use it to test the persistence of ROA as the bank's financial performance in Indonesia. The results show that banks with low-cost strategies having better and more persistence financial performance compared to banks

with a differentiation strategy. Further empirical test which considered bank characteristics provide consistent empirical results with the primary empirical model, suggesting that the empirical test results are robust.

These results have several implications. Theoretically, this study provides better understanding regarding how the strategic position affects financial performance and its persistence in the Indonesian banking industry. Most importantly, the use of secondary data to capture the features of the contrast position of low-cost and a differentiation strategy provide a more objective and more precise picture regarding the phenomenon. Consequently, the practical implications suggest that for Indonesian banks, a low-cost strategy is the way to achieve sound and persistent financial performance. More specifically, to have a sound effect on bank's financial performance, implementation of a low-cost strategy should maintain healthy proportion of PPE, loans and salaries expenses to net income.

Operationalization of generic strategies based on the financial data has some limitations susceptible to bias. First, the study results need to be interpreted with caution since the empirical results for low-cost strategy show that statistically significant impact exists only at  $t + 2$ , while for  $t + 1$  and  $t + 3$  and are not significant. Second, the reliability level is still quite low (Cronbach alpha  $< 0.5$ ). Finally, this study operates at the corporate level, hence, it does not capture the variability of business unit strategy. However, this research is challenging and interesting to be developed further. Further studies may lead to the development of a more comprehensive construction to capture the strategic orientation of the company not only at the corporate level but also winning the variability of strategic business unit of banks through a detailed field study (analyzed on a case by case basis).

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