

P E R S P E C T I V E

How Successful Banks Build
their Innovation Strategy



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Banks need innovation to sustain in future.

Corporate and retail banks are facing competition from new entrants and innovative business models. If that wasn't enough, shrinking margins and tighter regulatory requirements are adding to the pressure. Going forward, innovation is perceived as the key to growth and competitive differentiation. Only those banks that can successfully develop new products, services and channels in response to the changed market environment will survive. This is echoed by the findings of a recent survey of European retail banks conducted jointly by Infosys and the European Financial Management Association (EFMA), which state that 4 out of 5 respondents said that innovation was extremely important for achieving growth and efficiency.

The statement that the banking sector lags others in innovation is only partially true. While there hasn't been much disruptive innovation, which is the most visible kind, in this space, banks have steadily innovated behind the scenes on internal processes and back-office operations.

While there has been little disruptive innovation so far, that may change.

Most senior managements believe that they are on top of the challenges presented by the diverse forces of structural change, regulation and competition and claim that their banks routinely innovate to adapt to shifting paradigms. While they may be well-placed to handle predictable circumstances, can the same be said in the face of unforeseen events?

Once in a while, the industry may experience sudden change extending beyond familiar boundaries. Left unattended, unexpected developments can degenerate in quick time. Several industries have fallen victim to such change in the form of disruptive innovation, and while banking has remained largely immune, the emergence of new channels, technologies and participants could potentially bring about disintermediation of established players.

Zopa, a peer to peer social lending service in the U.K. that allows borrowers and lenders to bypass banks completely by connecting directly in an online marketplace, is a case in point. In the U.S., several Credit Unions have tied up with similar online lending platforms. While the jury is still out on whether social lending is a serious threat to conventional banking, there is no doubt that its simple and cost effective proposition holds much appeal.

Technology is driving banking innovation.

Historically, banks have innovated at a slower pace compared to other businesses. Regulation and risk mitigation has as much to do with this as the fact that the results of innovation take time to show, giving competitors a chance to match or even better a pioneering effort and negate any advantage of the first mover.

But now, the pace is picking up. Structured financial products like derivatives are the result of product innovation. Simultaneously, systems and process innovation have transformed the back-office, streamlined customer interaction and enabled several cost management strategies such as outsourcing.

So far, the Internet has been at the forefront of channel innovation, heralding first online and then, direct banking. But now, other innovative channels are emerging – with advances in convergence technology, IPTV and VOIP may well be the channels to watch out for. Interestingly, channel innovation need not always be technology-driven. Leading banks in the U.S. have used non-banking channels including pawnbroker networks to reach the largely unbanked Hispanic population!

Processes are driving banking innovation.

Generally, innovation is perceived as a breakthrough product or technology; in banking however, it takes on an additional dimension – that of the process. The processes surrounding a new product or technology are as important as their features and could add significant value by way of cost saving, improved productivity and so on. In fact, most recent banking innovations have focused

on improving the processes associated with the delivery of products and services, management of customer interactions and administration of back-office functions. At the same time, product innovation has been limited to a small range of fundamental offerings. However, because banking products and processes are so intertwined, the lines between the two are often blurred.

The following points highlight the contribution of process innovation to banking:

- Innovation of Internet-related processes has improved online banking adoption. While the first wave of the Internet revolutionized information sharing, innovation in the form of Web 2.0 catapulted it into “social exchange”. Using a variety of vertical tools such as wikis, mashups, blogs and surveys, users fulfill their need for information, entertainment and communication. Several banks around the world have caught on to this phenomenon and carved Web 2.0 spaces where they interact with customers, provide information, resolve problems, brainstorm and generally improve the banking experience.
- Automated and integrated back-office systems have enabled banks to outsource or offshore routine administrative and customer service functions. Centralized transaction processing in core operations such as credit risk assessment and loan approval has reduced the role of the local branch.
- Payment processes have been revolutionized by the introduction of chip-and-pin and contactless payment systems. Take for instance, Hong Kong's “Octopus” smart card, which can not only be used on the city's public transport system as originally intended, but also in restaurants and retail outlets. We can cite several other instances of smart payment mechanisms that have rendered cash redundant – for example, global money transfer via SMS.

Banks must establish a sound innovation framework.

Although banks may take different approaches to innovation, most are driven by the following needs:

- Grow revenue and profits
- Satisfy unmet customer needs by bridging gaps in products, services and processes, on the way to improving customer relationships
- Empower staff with tools that help resolve customers' problems

Banks measure and monitor innovation in a number of ways. Tier 1 banks routinely benchmark their own initiatives against those of their closest rivals in order to maintain their competitive edge. This is how they do it:

- **Employ market studies and sampling to assess current capabilities:** Banks frequently ally with consultants and technology partners to evaluate new markets and formulate an appropriate competitive strategy. Business intelligence solutions help to answer key questions related to the size of market opportunities, competitor strength, level of technology deployed, and so on.

In markets where they already have an established presence, banking institutions can evaluate their performance by analyzing customer satisfaction, retention and advocacy and benchmark these parameters against those of their biggest competitors to arrive at their true performance and relative strengths.

- **Define the role of innovation in the long term and a roadmap for achieving its goals:** To start with, banks must have a clear vision of the role innovation must play within the organization. Next, they must formulate the right strategies, ensuring that they are in sync with larger business goals. Taking a holistic approach, the bank must set up an organization-wide innovation framework comprising strategies, guidelines and measures to ensure that the innovation agenda is both understood and implemented on the ground.
- **Evaluate the cost of innovation versus expected economic benefit:** Most banks plan ahead and allocate financial resources for their innovation projects. On the cost side, they need to budget for marketing and related expenses including insight gathering and product

development and for process improvement, which entails IT investment. It is equally important for them to assess the efficacy of their efforts. Using the balanced scorecard and various operational metrics, they can measure how much innovation has contributed to business growth, customer retention, advocacy and other parameters.

- **Build a strategic team to implement their innovation portfolio:** Organizational focus is a prerequisite for innovation success. Thus, banks must dedicate a multidisciplinary team to drive the agenda. While senior executives take the decisions, they must have the support of various business units as well as middle and junior-level staff that are responsible for execution. Many successful banks have set up “incubators” to encourage and reward innovative thinking among employees.
- **Mitigate risk by being prepared with an alternate plan or a roll-back mechanism in the worst case:** While innovation promises much, it also carries significant uncertainty and risk. Moreover, banking innovation faces several hurdles in the form of compliance mandates, operational silos, excessive caution and red tape. At times, these constraints might outweigh the compulsions to innovate; worse, this may happen during execution. It is therefore imprudent for banks to green-light any innovation without having a viable exit option. Interestingly, incremental innovation may provide the right risk-reward balance, and many banks have successfully altered products, processes and channels by innovating in small steps.
- **Bring clarity to “innovation thinking” with the help of external consultants, benchmarking studies and formal exchange of learning with partners and peers:** While innovation experts bring wide experience and knowledge of different markets to the table, their ideas can only be implemented on the back of robust technical infrastructure. In the retail bank survey mentioned earlier, inflexible IT systems and bottlenecks in development were cited as the top 2 barriers to innovation. Thus, it is important to partner with technology vendors having

access to a full range of insight techniques and the ability to configure products and services around their client's needs.

Last but not least, banks can take the open innovation route, whereby they can collaborate with third parties to generate innovative ideas.

Innovation needs organizational support to succeed.

The banking industry is facing multiple pressures. On the one hand, banks have to adapt to greater regulation, competition and consolidation, which are largely out of their control; on the other, they have to meet increasingly diverse and demanding customer expectations. Most realize that innovation is indispensable to their future growth and sustainability. Those with serious innovation intent must give it the best chance of success by laying the groundwork in the following manner:

- Prioritize innovative actions that raise enterprise effectiveness by improving business processes
- Move with agility, before the value of innovation and the bank's competitive advantage diminish
- Ensure adequate modern technical infrastructure, which would not only use fewer financial and energy resources, deliver better performance and provide greater capacity but also help to incubate innovation

Author

Bhaskar Banerjee

Consultant - Product Strategy: Finacle UBS
Infosys Technologies Limited



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Universal Banking Solution | System Integration | Consulting | Business Process Outsourcing

Infosys Technologies Limited

Plot No. 44, Electronics City, Hosur Road, Bangalore - 560100, India.

Tel.: + 91 80 28520261, Fax: + 91 80 28521747, e-mail: finacleweb@infosys.com

www.infosys.com/finacle/networking.asp

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