Managing
INNOVATION RISK

By Madhabi Puri Buch

Generating return on innovation without betting the bank

Risk in banks is nearly always considered a dirty word. Yet a handful of simple ideas can help manage innovation risk effectively.

Innovation, almost by definition, is a risky business. But the returns that banks generate are almost exclusively for managing risk (prudently), rather than for staying away from it altogether. A handful of simple ideas can help manage innovation risk. When institutions are alert and see every strong emerging consumer or technology trend as an opportunity to build competitive advantage, there could be significant return on innovation waiting to be harvested.

Back to the future in ancient Babylon

The time was 2000 BC. The high priest of the temple had just finished carrying out his religious duties for the morning and was making his way to the courtyard to supervise the acceptance of grain from the local farmers into the temple's granaries for safe-keeping. As always there were those farmers who were pleased with their harvest. Others grumbled. Suddenly, his young assistant, who was widely touted to succeed the high priest, turned to him to ask a rather provocative question. "What if the temple were to loan seed-grain to farmers who didn't have any, and recover the repayment with interest from the next harvest?"

There were gasps. The buzz in the temple was fast and furious. "Another crazy idea from that young whippersnapper." "Are you out of your mind?" "That would be a foolishly risky thing to do." "How could we be sure we'd get the grain back?" "What if the owners returned early and asked for their grain back?" "What if there is a drought next year?" "Do you want to succeed me as high priest or not?"

But that was how modern banking was born. Credit risk, liquidity risk, and market risk became part of temple life. The assistant's "one bright idea" probably saw him well on the way to becoming high priest.

Innovation and the R word

The world today is abuzz with two strong forces shaping its future. The first is the drive for banking to become even more boring (we have had enough innovation in financial engineering for a while), and the second is the push for technology to do more and more for the common man. We just don't seem to get enough of the latter. In respecting both of these forces, this article focuses on innovation as it relates to consumer and technology trends alone and how innovation in this space can help banks build competitive advantage in the core business of serving their customers.

But innovation, almost by definition, is a risky business. Innovation is about something new and something that is new is usually not proven and is characterised by uncertain outcomes and unknown problems. Something that is new is usually created by new companies, which by definition are those without established track records and with an unpredictable future. As a result, an employee in an organisation can lose his job for doing something new ("Well, that did not go so well") but can rarely lose his job for not doing it—who is to know what opportunity was lost? And while this is true for many organisations, it is particularly true for banks. And perhaps rightly so. Banks deal with their customers' hard-earned money, often their life savings, and all of their financial information is highly confidential. None of this can be treated lightly.

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Naturally, we would all like our bankers to be concerned about taking risks with our money or our data. However, we would

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also like our bankers to think about and work hard at making our lives a lot easier; indeed technology is giving them an opportunity to do so. We would like them to learn to manage innovation risk, just as they learnt to manage credit risk and market risk in order to deliver returns to depositors and shareholders.

Darwin@work in banks

Risk management in banks has evolved. Many would argue not far enough, as the events of 2008 taught us. This is true, and we need to continue to learn and to evolve. The building blocks of effective risk management, while reasonably well understood, are continuing to evolve. There are several models to measure potential risk and potential return for a new initiative. Banks have also developed policies on what kind of risk-return profile they want as well as practices on how to mitigate known risks; and standards have been established on how to provision for residual risks. Over time, regulators have also introduced guidelines to prevent excessive concentration of risk

Fortunately, in some jurisdictions like Singapore, regulators are proactive and forward thinking. They are astute and clearly see the emerging consumer and technology trends, anticipate demand from citizens to adopt any new technology, and proactively issue guidelines[i] as a frame of reference for the banks as they learn to mitigate innovation risk.

So the ball is squarely in the court of the banks. They need to evolve their innovation practice to deliver new value to the customer, manage the embedded risks prudently, build competitive advantage for themselves and deliver return on innovation to their shareholders.

Building the innovation practice

A suggested framework for building a strong innovation practice might include some of the following ideas. They are by no means comprehensive.

1. FROM INSIDE TO OUTSIDE

An interesting thing about the service industry is that before a customer gets served, an employee gets served, either by the system or by another employee. And so, almost any innovation that you would like to serve to the customer can first be served to–and be tested–by employees. This takes place in a very controlled, ring-fenced, risk-mitigated manner. Examples of possibilities include a new mobile application, a new biometric authentication engine, or a new analytics-based advisory service. The possibilities are endless.

So innovate internally and innovate early. As soon as things stabilise, just turn the innovation outward.

2. FROM THE ICING TO THE CAKE

An interesting thing about icing is that it really does make a difference to the taste of the cake, without ever getting into the cake. There is a good reason why critical systems within a bank are called "critical". They are. And it would be a bad idea to touch them except when the highest level of confidence in doing so is present. But there are a large number of services that can be delivered to the customer, that either don't touch the critical systems, or touch them in a highly controlled manner. For instance, location-based merchant offers to your credit card holders can be offered without ever touching your core credit card system.

So innovate at the edges, innovate early, and as soon as things stabilise, allow the innovation to go in deeper.

3. FROM SMALL TO BIG

An interesting thing about money is its materiality, both for the bank and the customer. And bankers have practised the art of limiting risk by limiting the size of transactions ever since time immemorial. Daily limits on ATM withdrawals, limits on online transfers and alerts for credit card charges beyond a limit have served banks and their customers well in terms of mitigating risk while improving the convenience quotient of a bank's service offerings.

So it's useful to allow innovative transaction modes for small values. Only when the technology proves itself, should you move to bigger things. Chances are Pareto's 80-20 principle will apply and you might never need to move very far from small.

4. FROM ONE-WAY STREETS TO EIGHT-LANE HIGHWAYS

An interesting thing about customer service is that the traffic on the two sides of the communication road is not equally sensitive. Just because data going out from the bank has to be highly protected does not mean that queries coming into the bank have to be highly protected. For instance, a bank might allow any number of channels to integrate with its customer service system to log in a query. So long as the answer to the query goes out only to pre-registered, pre-authenticated channels like the customer's registered phone number, email or postal addresses.

To allow infinite innovation for the non-sensitive legs of communication, innovate early. When the technology evolves enough to provide a high level of comfort, open up the other side of the highway.

5. FROM BETA TO LIVE

An interesting thing about customers is that they are not all alike. They have completely different responses to innovation and in their personal capacity, could be early adopters or laggards, or any group in between. Somehow we assume that we need to cater to the least common denominator when we do something new for our customers...

Taking a key learning from the tech industry: If we were to launch every new service in beta mode, we would clearly signal to our customers that not every crease in the offering has been ironed out (barring security, of course, where required, as this is non-negotiable for bankers), and, that "in the interest of getting constructive feedback from our customers, we are making a beta version available".

Not only would we be able to move nimbly on innovation, and take little or no flak for initial teething troubles, but also we would also genuinely obtain valuable customer feedback that would actually help us refine our offering and make it more valuable to the customer.

So launch in beta, manage expectations, get valuable customer feedback before going live, and position the bank as a true blue Innovator, able to ride those trends that seem to be firmly entrenched in the world.

> **BUILDING AN INNOVATION PRACTICE**
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> **1. FROM INSIDE TO OUTSIDE**
> In the service industry, almost any innovation that you would like to serve to the customer can first be served to - and be tested - by employees in a very controlled, ring-fenced, risk-mitigated manner. Innovate internally, innovate early. And in the fullness of time, turn the innovation inside out.
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> **2. FROM THE ICING TO THE CAKE**
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The big four trends

So where is the pot of gold in innovation? Many trends emerge and many die out as well, sometimes fairly quickly too. But the good news for banks is that they need only ride the reasonably established trends and not invent the next big one. And that brings us to SMAC. These are the big four trends that look like they are here to stay and are growing bigger and bigger by the day.

S: SOCIAL MEDIA. When people stop thinking of Facebook as cool and start thinking of it as a necessary utility like electricity or water, then it looks like its here to stay. The facts are that there are one billion active Facebook users every month, with 50 percent of them logging in on any

INNOVATION, THE BIG FOUR AND THE BIG O

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M: MOBILE. When mobile internet access in China (75%) surpasses PC internet access (71%) and penetration of smart phones grows at 52 % per annum in India, mobile has indeed arrived.

A: ANALYTICS. When 92 percent of all the data in the world has been created over the last two years, and McKinsey estimates that Big Data could generate over US$1 trillion in revenue/savings per year, it is very much a part of the future

C: CLOUD. When Gartner estimates that 60 percent of all server workloads will be virtualised by 2014, it looks like it deserves a serious look.

O: OPEN INNOVATION. When hundreds of entrepreneurs and angel investors across the globe want to build innovative services for your customers for free, maybe you should let them!

> Building a low risk innovation practice: innovate inside, innovate on not-so-critical systems, innovate small, innovate on non-sensitive legs of communication, induct your customers into your innovation.

given day. Around 48 percent of 18-34 year olds check Facebook when they wake up, while 28 percent of them check the social media site before they get out of bed.

M: MOBILE. When China declares that mobile Internet access (75 percent) has surpassed PC Internet access (71 percent) and India declares that smartphone penetration is only six percent of the total subscriber base of 1.1 billion but growing at 52 percent, it looks like it is becoming serious.

A: ANALYTICS. When 92 percent of all the data in the world has been created over the last two years, and machine-to-machine data hasn't even begun, and when McKinsey estimates that Big Data could generate over US$1 trillion in revenue/savings per year, it looks like this is very much a part of the future.

C: CLOUD. When Gartner estimates that the size of the cloud computing market could reach US$150 billion in 2013 and that 60 percent of all server workloads will be virtualised by 2014, it looks like it deserves a serious look.

The mega trend: The big O, open innovation

To my mind, the most interesting thing about innovation today is that organisations don't need to drive it internally alone. There are a large number of innovators out there who are willing to innovate for your customers free–if only you would let them. There is a huge and growing ecosystem of entrepreneurs and angel investors who will passionately pursue the development of value added services for your customers, if only they could speak to you and your systems.

As a bank, even if it is only in line with the spirit of "One Way Streets", if you were to permit them just one way access, you could open up a huge opportunity for innovation and value addition for your customers. All of it for free!

This then is the power of Open Innovation.

Rewinding to the future, imagine that you are the assistant to the high priest at the Great Temple of Babylon in 2014. What would you want to say to the high priest? "Is it possible to generate Return on Innovation without betting the bank?"

Madhabi Puri Buch

is a director at Agora Partners Pte. Ltd.

Reference

[i] Monetary Authority of Singapore (MAS) Technology Risk Management Notice and Guidelines, June 2013: In recent years, various technology innovations in areas such as card payment, mobile technology and system virtualisation have helped to expand financial institutions' (FIs) business offerings and customer reach. Information technology (IT) outsourcing has also become more attractive to FIs due to the abundance of outsourcing services. Against the backdrop of an increased reliance on complex IT systems and operations in the financial sector is the heightened risk of cyber attacks and system disruptions. In this regard, FIs are expected to continue to deepen their technology risk management capabilities and be ready to handle IT security incidents and system failures.