The Innovation Requirement

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OVERVIEW

Since the crisis of 2008 we have seen significant change within financial services, however, much of the action taken by market players has been reactionary and defensive. Although a great deal has been said about the excesses and errors of the past, the current focus for banks, in particular, must be on the need to innovate or risk becoming stagnant and losing the ability to compete for exceptional talent. In this matter, banks should take a lesson from today's leaders in technology.

COMPARISON TO THE TECH INDUSTRY

In the most recent Steve Jobs biography, his obsessive focus on innovation was a consistent theme. Throughout the technology and internet world, firms have tailored their human capital / reward strategies to promote innovation. Firms like Apple, Google, Microsoft, Amazon, Twitter and Facebook consider innovation a core competency. Sure, they think about costs, they think about execution and they think about efficiency, but the lifeblood of these organizations is innovation. Can you imagine what Apple's product offering would have been over the last 10 years if their primary focus was on cost-cutting versus making great products?

One interesting, and telling case study to consider is that of PayPal, which is, quite simply, a financial services firm. Their service, launched in the technology space, was subsequently purchased in a deal valued at $1.5 billion. Why was a small firm with a handful of employees able to innovate and develop a service like this, while larger banks, with tens of thousands of employees, were unable to develop something comparable? The answer seems to be a combination of focus and agility.

Banks may look at innovation with a jaundiced eye due to prior attempts that soured, such as securitized mortgages and other credit derivatives. Yet, despite previous failure, there is still enormous opportunity to innovate. The question to consider is this: "Within human capital management and reward, how can we encourage and drive innovation at banks today?"

THE RISK OF BRAIN DRAIN

It's no secret that the best and the brightest graduates are now heading to technology firms. Some of this attraction is driven by the reputational "black-eye" financial services has taken since the recession. But consider the following question asked by a bright young person leaving university, "If I have a great idea for a product or service and enter a Wall Street analyst program, will anyone listen to me?"

The current approach to career progression, titling and compensation at a bank puts too much emphasis on tenure and a "one size fits all" role structure, with very little focus on achievement, innovation or flexibility. As a result, it has become commonplace for the best minds in higher education – who want their ideas to be heard and rewarded – to believe success through innovation is more easily achieved outside of banking. Technology companies are well-known for being nimble and bringing ideas to market quickly.

Since the financial crisis, compensation levels at banks have been falling and headcount has been reduced. This has opened the door for smaller, less-regulated firms and sectors to lure some of the very best talent away from large banks. The emerging culture of less bureaucracy, more independence, greater transparency around pay, and more opportunity to innovate has attracted top talent. And as talent leaves the largest firms it has a real impact on market share, particularly in roles where individual intellectual capital is more important than franchise value.

ENCOURAGING INNOVATION

It is not too late for large financial organizations to shift towards a new cultural orientation that can drive real change. However, firms trying to change the agenda are frequently pulled back into the same dialogue around risk, control and pay levels by their boards, shareholders and the public at large. There will need to be senior management buy-in and an unrelenting and deliberate focus to effect sustained change. The fundamentally required components include:

- Reward systems that compensate game-changing contributors greatly and de-emphasize “clock punchers.”
- Flexible career paths and job structures that focus on contribution and can be adapted to changing circumstances – given that different groups of employees may be better motivated or developed by different structures even within the same firm.
- Pipelines or greenhouses to nurture innovation and ensure they are staffed with the appropriate talent.
- Shift of vision and focus from repeating techniques and initiatives that have previously not proven material in adding value (i.e., outsourcing) to those that build excellence, result in great products and services, and differentiate capabilities.

REWARD SYSTEMS

It has been well documented within Asset Management that out-performance (in this case driving alpha) is both elusive and fleeting and, as such, firms need to be able to act quickly and decisively to reward, retain and motivate the very best talent. As banks continue to move more compensation into fixed pay they are positioning themselves further away from this key concept. There will be less and less flexibility to reward the true stars, and large banks will get pushed towards operating like quasi-governmental organizations which offer slow, steady, increasingly socialized pay driven primarily by tenure rather than value-added. So, what kind of pay structures can help reverse this trend?

- Limited fixed pay and plenty of incentive – in all areas of the firm (even call centers). The goal is to recognize and reward excellence even for people doing repetitive tasks.
- Hyper-differentiation so that high performers get paid a multiple over low performers doing the same job – there simply isn’t enough money around to pay low performers at “market rates.”
- Highly levered, option-like vehicles linked to performance of smaller groups (not overall firm) – if your team innovates, and builds something great, you get a huge reward.
- Broader use of carry plans – top talent will stick around when they are getting paid on the outcome of their transactions. This approach can also be used

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effectively within innovative teams to shift the focus from individual to team performance.

- Shift focus of pay away from “class year” approach. Top talent coming out of school wants to be paid for their great ideas now. Tenure-driven pay stifles firms’ ability to reward great-thinking junior employees, and encourages firms to overpay longer-tenured lower contributors.
- Free up funds for “spot awards” to recognize great ideas quickly and create a culture that celebrates good thinking.

JOB STRUCTURES

The job and career progression configurations at banks, like the reward systems, tend to rely too heavily on tenure and inflexible structures to the detriment of these firms. Much has been written and observed about the millennial generation and their need for ongoing recognition of their achievements. Perhaps it is not surprising that the most talented of this generation choose tech firms with flatter structures and greater ability to recognize and reward staff more quickly. To reverse this, banks need to:

- Build career progression models that recognize achievement, not physical age or length of service.
- In developing promotion and advancement criteria, consider innovation more heavily and tenure and scope of responsibility less heavily.
- Think about promoting innovators into management roles.
- The highest producing salesperson or trader may not be the best leader and asking them to lead may reduce their capacity to produce – consider innovation cultivators for management positions.
- Consider dual career paths, including one for non-managers who make extraordinary, innovative individual contributions, thereby creating a richly rewarding opportunity for people who do not manage staff.

PIPELINES / GREENHOUSES

At most large banks only the senior most staff have the ability to get a new idea heard by C-suite executives. Consider the following:

- Monthly innovation meetings where even entry level employees can have their ideas brought to the attention of the CEO, or his designees. Imagine the negative effects of being a firm of fifty thousand or more employees with only a few of their ideas getting air time.
- Consider small think tank-like structures that simply generate ideas on a full-time basis – they don’t all have to be executed, but they can certainly be considered and rewarded.
- Create team structures where entry level staff have the time to develop their ideas rather than just make pitch books as fresh thoughts drive new outcomes.
- Create ways to identify staff across divisions who are natural innovators and move them to environments where they can flourish and be recognized.

Furthermore, consider acquiring or sponsoring small, agile “tech-like” firms that are accountable for outcomes, but are not confined to overall firm structures. In the heyday of the music industry, large record labels knew they could never innovate as quickly as small independent labels, so they simply acquired them, and let them source new talent and ideas. The record companies were less focused on the popular bank mantra of

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"one firm", as they knew that leaving these little entities free to be true to their own DNA would produce the best outcomes.

FOCUS

While it is reasonable for firms to focus on cost-cutting, particularly where larger firms may have real opportunities to trim costs, there is too much opportunity on the innovation front to have cost-cutting remain the primary strategic focus. Consider the following as just a few opportunities that demand innovation and determine whether firms are focusing on innovative solutions as much as they should:

- An enormous number of "un-banked" people are moving into the middle class throughout emerging markets – this is an opportunity of unprecedented proportions – who is building the forward-thinking products and services to serve this market?
- The European financial crisis has created tremendous investor exposure to unstable sovereign debt – who is creating the financial solutions for these investors?
- Currency markets, particularly related to China, but also for European nations considering the pros and cons of life under the Euro, have created substantial opportunities for advice and product offerings – where is the thought leadership coming from?
- Pension and annuity vehicles are facing challenges, as are governments with unfunded obligations – what are the innovative solutions being offered for these clients?
- As the internet changes how we shop, pay for things, and interact, what is the next PayPal and who is building it? If you built the next PayPal what would be the cross-sell opportunity to a global client base, beyond just revenue opportunity?

CONCLUSION

An unintended consequence of the increased regulatory and public pressure to control banks has been a stifling of innovation. Banks have access to inexpensive capital, and can easily return to a modest and steady lending model, which will not require great innovation or talent. But there is so much more that could be done. Human Resources and Compensation professionals have also seen a material shift in their roles from advisory to control, but we are starting to see groups trying to redress the balance and partner with firm leaders to add value as they create the kinds of structures and pay programs that push firms towards innovation, excellence and change.

With limited time and resources, firms are moving away from a herd mentality, to consider what is right for their specific firm. This means there may be more openness to structures that would not have been considered in the past. Who will dare to be really different, and be the "Apple" of the financial services world?

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