

Innovation in Financial Services



HCI White Paper

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EXECUTIVE SUMMARY

Despite common belief, the amount of spending on research and development does not necessarily translate into better innovation and bottom line results, particularly in the industry of financial services.

Goran Hagegard, Principal at Booz Allen Hamilton, explains the project called Innovation 1000. "This was a primary research project that utilized information on the 1,000 research spenders or innovation spenders in the world." They found, according to Hagegard, that "...money can't buy you results."

Hagegard offers an overview of Booz Allen Hamilton, and the details of a case study involving a mortgage originator that found itself in economic trouble and engaged the expertise of Booz Allen Hamilton to make the changes necessary to keep the company alive.

BOOZ ALLEN HAMILTON OVERVIEW

Booz Allen Hamilton (BAH) was founded in 1914. It is an organization that "combines strategy with technology and insights with action, working with clients to deliver results today that endure tomorrow."

BAH operates globally with more than 18,000 professionals in more than 100 offices on six continents. The organization deploys a full range of strategy, operations, innovation, organization, and IT capabilities. It is a \$3.7 billion private firm owned by more than 300 partners. Their client base encompasses the world's leading private and public sector institutions including 75% of the 100 largest

companies, 85% of the world's largest telecom companies, 70% of the world's largest media companies, 80% of the world's largest software firms, and governments of over 40 countries.

"BAH has a 50-plus year tradition of innovation thought leadership and in assisting clients achieve improvements in strategy, processes, and IT systems across the entire innovation life-cycle," says Hagegard.

ABOUT THE STUDY: GLOBAL INNOVATION 1,000

The second annual Global Innovation 1,000 examined conventional wisdom about the link between R&D spending and performance. "This is an attempt, in a primary research kind of way, to determine the sources of good innovation. Where does it come from? Can we prove that there are some categories and some ways of spending that are better than others?"

The study analyzed publicly available data since 1999 for 1,000 of the largest R&D spenders in the world. Its objectives included:

- o To understand how R&D spending is the driving force behind corporate sales growth, profit levels, and stockholder value creation.
- o To continue to research how organizations can maximize their return on innovation investment.
- o To highlight specific examples of effective innovators and glean success factors.
- o To highlight regional and industry differences in the role and impact of R&D investment.
- o By revisiting annually, to understand how factors change over time.

"We've confirmed that higher R&D spending does-

n't ensure better performance in terms of growth, profitability, or shareholder returns," states Hagegard. "The conclusion was not that money doesn't matter, but that we went through about 10,000 different kinds of analyses - both advanced and less advanced - but we really found no statistical relationship between outright R&D spending and sales growth, profit growth, operating profit growth, and so forth."

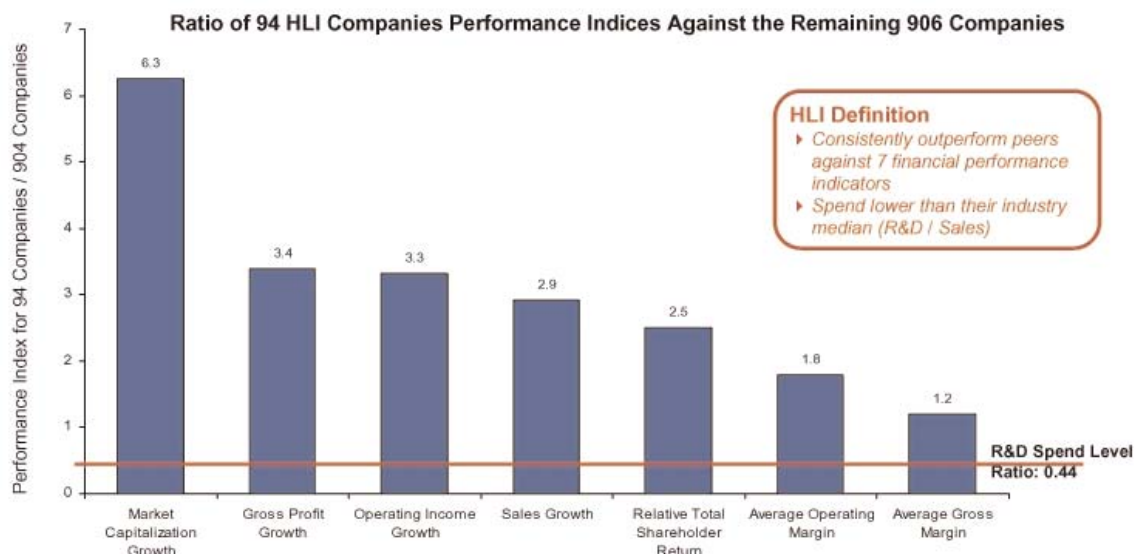
Hagegard contemplates, "How can you ensure better performance? Well, maybe you can't. However, we tried to find some examples of people who did it well." He refers to these examples as "High Leverage Innovators," which are organizations that consistently outperform their peers against seven financial performance indicators and spend lower than their industry median (R&D/sales). [See Figure 1 below.]

"Throwing money at the problem isn't really the answer," says Hagegard. "We looked at companies that consistently outperformed their peers against these indices. They spent only 44% of the average and got much more out of it."

One key finding is that innovation process and culture matter more than R&D spending. Hagegard suggests four other points for organizations to consider when they attempt to improve their bottom line through innovation:

1. Align innovation strategy with corporate strategy. When this alignment takes place, all functional silos have incentives to support corporate and innovation strategies.
2. Make the right bets. This imperative requires managing not only the portfolio of projects and technologies that will maximize tomorrow's profits, but also the portfolio of business models needed to bring them to market.
3. Manage the product development pipeline with speed and efficiency. It is critical to have clear processes both to manage the innovation effort (i.e. stage gate) and to support it (i.e. knowledge management).
4. Ensure innovation "OrgDNA" is healthy. Because entities with healthy organizational DNA profiles significantly outperformed those with dysfunctional ones, companies and R&D departments need to take steps to ensure healthy OrgDNA.

Figure 1



"It's about roles, responsibilities, incentives, how you make decisions, share information. It's not just about structure." Hagegard adds, "Money alone can't buy results because results in all the key metrics that we want to improve as business managers seem to be unrelated to the number of dollars that we spend. So there are other conclusions to be drawn."

MANAGING INNOVATION

Managing innovation in a financial services context is challenging, and in many ways different, from a product environment. Only a superior innovation capability can create a sustainable advantage. It is virtually impossible to create sustainable competitive advantage with a single innovation. Most innovations in financial services can and will be copied by competitors.

"If you think about how financial services have been driven during the last 15 years, it has really been driven by the advancements in technology, and some would say that the technology has advanced much faster than consumers or corporations have been able to adopt the processes that the technology has allowed."

Financial services companies need to manage the matrix of market and product and platform. Hagegard says, "Innovation's purpose is market facing. It's about serving customers, but it impacts multiple products serving multiple markets that reside on different platforms. Further, organizations involved in financial services need to combine the aspects of products, service delivery, and production process in the innovation process, which increases complexity."

The innovation process is inherently cross-functional which creates organizational complexity. There are often organizational barriers between both business and IT organizations and between business organizations. Hagegard refers to these barriers as "the moat."

"Innovation and product development is expected of line management rather than a separate R&D department, creating further cross-functional issues and placing great strain on line management," he adds.

"We believe that effective innovation starts with a clear view on the role of the company in the innovation game," says Hagegard, and he gives several examples of different innovation approaches. Some are more market-driven and some are more R&D driven; some are passive while others are aggressive. See Figure 2 for detailed descriptions of some examples.

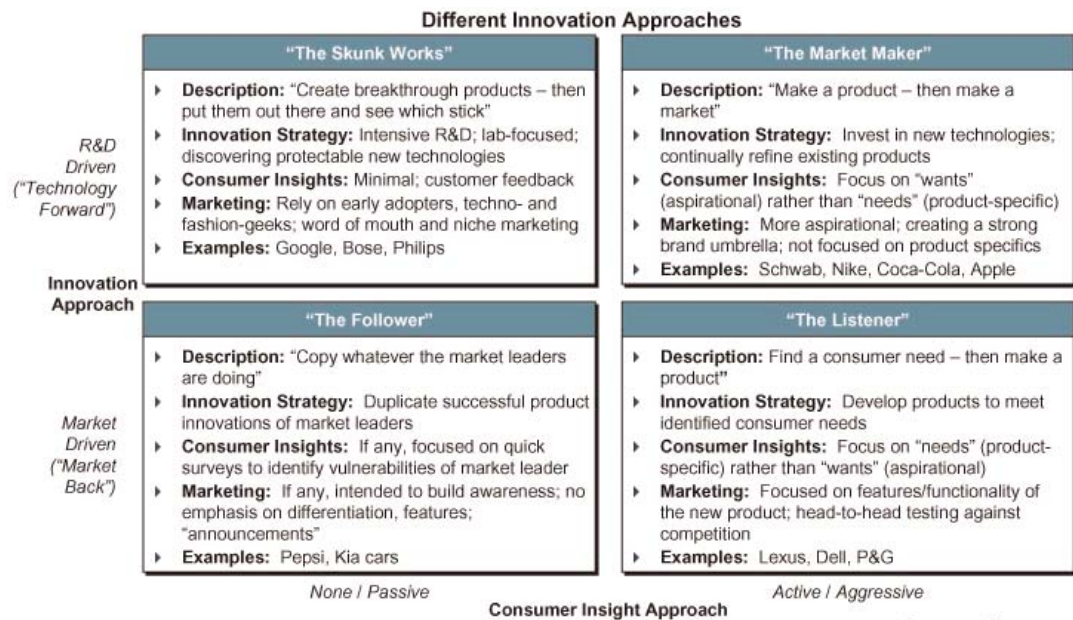
"The Internet really turned everyone in financial services upside down. It brought information to our fingertips, much, much more than the PC ever did. It drove customers closer to financial services institutions. It made feedback much easier, made switching cost less."

CHOOSING A STRATEGY

Choosing the right strategy will help build the right innovation capabilities to deliver on that strategy, explains Hagegard. Some key points that leaders need to consider include:

1. Strategic business processes include innovation strategy, product strategy and roadmaps, portfolio management and technology planning, and

Figure 2



product architecture.

2. Product/Service/Process Development includes: ideation, stage-gate process (describe idea, develop concept, investigate, design, develop, test, pilot, market, launch), and life-cycle management.

3. Management Processes include: program and project management, resource (staffing) management, measurement and control (good metrics are important)

4. Organization Enablers include: information, structure, decision rights, and motivators.

"The right organization will enable your people to drive innovation - or drive it to a standstill," Hagegard says.

FOUR BUILDING BLOCKS OF THE INNOVATION'S "ORGDNA"

Hagegard further explains the idea of a healthy

"Organizational DNA" or OrgDNA, and how it applies to specific areas within an organization:

1. Decision Rights: decision authorities and responsibilities as black and white as possible to streamline decision flows (e.g. between functions and projects). Who makes what decision? How do you manage group decision-making?

2. Motivator - Incentives: senior management committed to innovation, dissenters are valued, risk-taking is encouraged, ideas are rewarded; freedom for employees to spend part of their time to think of and work on new ideas; resources available to fund work on new ideas.

3. Information: innovation strategy is shared and understood throughout the company; lean set of innovation metrics in place and closure of the loop on performance; appropriate decision-making forums; knowledge and ideas are fast and widely shared by appropriate incentives.

4. Structure: cross-functional empowered

teams for innovation processes in place; lean but empowered innovation management group in place (for coordination); resources available to dun work on new ideas; "slow" fast career track - encourage rotation providing people with a broad exposure to functions and sites.

A CASE STUDY

Hagegard explains a recent case study involving a financial services organization. "Our client, a mortgage originator, faced a sharp downturn in the market and needed to improve speed to market. The client faced rising mortgage rates and decreasing originations, combined with reliance on a few single products, quality issues, disparate processes and process disconnects, leading to a staggering drop in profit by almost 85%." [See Figure 3, below.]

"One of the things that they started understanding was that unless they got a true ability to change, to turn out new products and follow the waves that came along, they would keep losing market share."

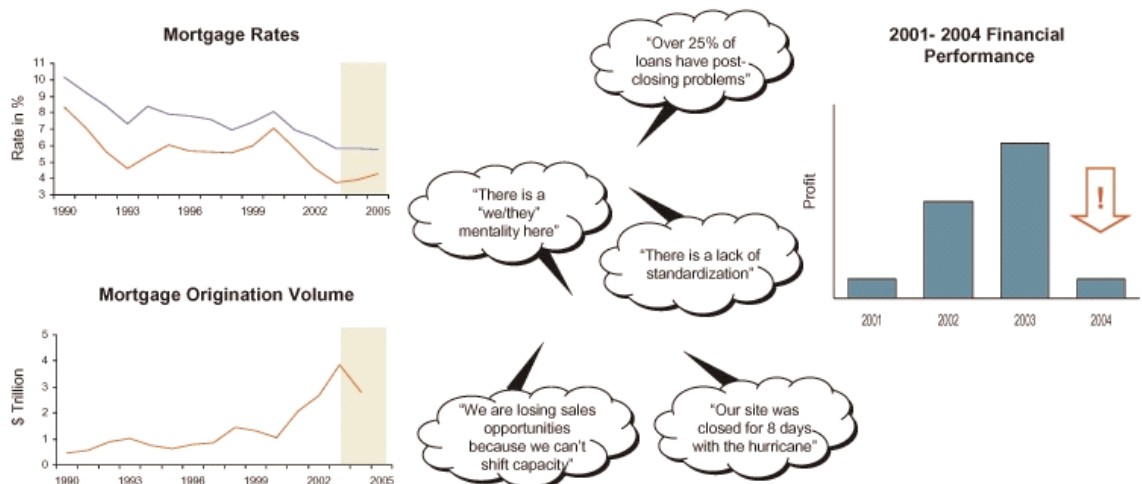
BAH was asked to work together with senior client management to validate and refine a new organiza-

tional model to start building capabilities critical to improving time to market and organizational agility. BAH conducted internal interviews and external research, evaluated the vision against the strategic goals, and assessed a number of options to create a revised organizational vision. They went through a lot of organizational models to see what would work best with the organization.

The innovation was driven by the entire organization. Restructuring objectives included:

- o Channeling agnostic processes: common processes and technology across the retail, correspondent, and wholesale channels
- o Optimizing site configuration: consolidation of sites to align with geographic needs, consistent spans of control across managers
- o Process overlay organization: senior level staff manages day-to-day site operations, senior level staff manages process, systems, metrics and standards across horizontal processes, common process and technologies across channels, sites and products

Figure 3



Based on initial analysis, the joint team developed an organizational model that balanced the four key objectives. Hagegard says they utilized BAH expertise and intellectual capital to validate initial hypotheses around the model and to make refinements for the client's unique situation.

"Basic models allowed senior management to very clearly discuss organizational options and implications that those options will have. They tied organizational objectives to strategic objectives"

He explains that while the model was viable, the implementation posed significant challenges. It involved defining the details of the organization:

- o Structure: aligning the business and culture to the new vision and process-based training; linking the disparate processes; identifying the appropriate functional managers and process owners.
- o Information: building the appropriate management tools to support the business; disseminating information to the right people at the right time; creating a transparency of information throughout the organization.
- o Motivators: designing appropriate compensation policies and plans; aligning incentive structure with the objectives of the vision; providing adequate training for the new roles.
- o Decision rights: determining accountability and responsibility matrices; designing the decision-making approach for day-to-day operations.

Additionally, the transformation had to reshape the organization's processes and IT systems, such as:

- o Standardized processes: standardizing core

processes to create cost efficiencies; determining a standard to improve quality and consistency; bridging the gap between servicing and fulfillment to provide better services to both consumers and investors

- o Standardized technology: replacing antiquated legacy fulfillment systems; standardizing technology across functions to further connect processes; providing access to all relevant parties to encourage collaboration

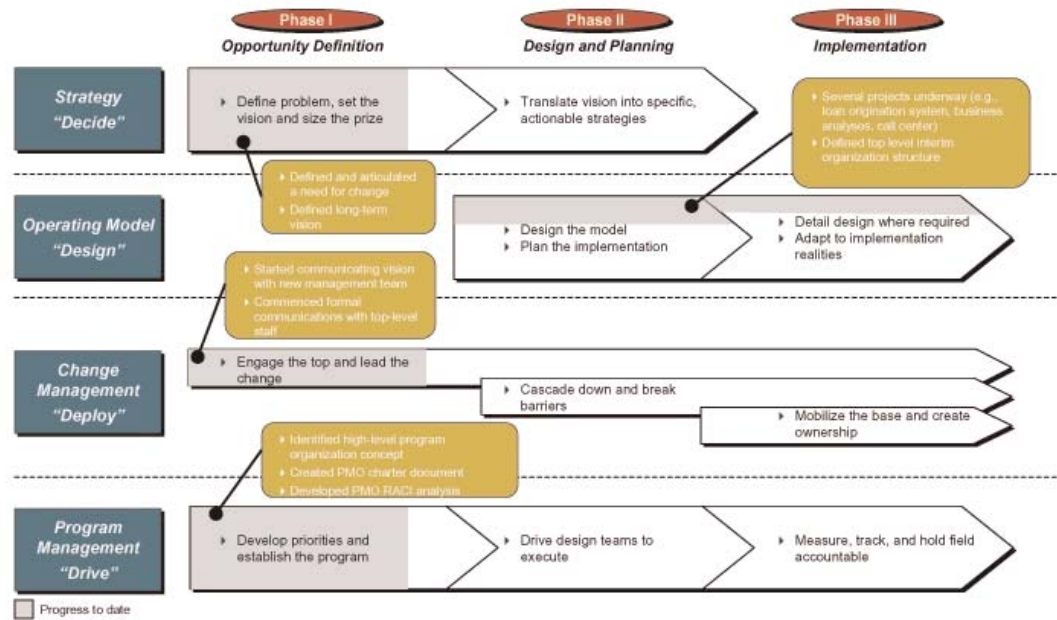
Finally, senior leaders had to manage transformational change by:

- o Engaging the tip and leading the change: building the leadership team and mobilizing stakeholders; establishing the case for change and crafting the vision and direction.
- o Cascading down and breaking barriers: identifying and empowering key agents of change; rolling out communications plan; articulating clear decision rights and performance metrics.
- o Mobilizing the base and creating ownership: rolling out implementation and change programs; monitoring key processes and results.

"If you want to mobilize the base and you want to create ownership," explains Hagegard, "it is not a question of dictating this is the way we want to do it, but about engaging people in the process."

To guide the implementation, BAH helped the client set up a transformation program structure made up of three phases: opportunity definition, design and planning, and implementation. These phases included four steps: Strategy (Decide),

Figure 4



Operating Model (Design), Change Management (Deploy), and Program Management (Drive). See Figure 4 for more detailed information.

"On a more detailed level," says Hagegard, "we helped define the program management office (PMO) structure and align it with the decision-making body. When our strategy work was complete, we helped kick start the implementation through guiding the next level of design."

The end result of the transformation, according to Hagegard, was a clear vision, a structure in place to manage the change, and a charged management team starting to lead the transformation effort.

"The client was ready to drive the transformation forward with a new management team that was motivated and empowered. The executive sponsorship was confident in the path. The program management office was structured and launched. The decision-making meeting scope and cadence was defined. The second and first wave of communications was crafted. The recommended near-term

plan was executed, and the implementation was underway. The client was ready to reap the benefits of its vision which included: improved flexibility and an ability to scale volumes as demand changes, improved cost efficiency through an ability to leverage the economies of scale across geographic locations, standardized processes and technologies, and improved business continuity through an ability to shift processing in times of emergency."

CONCLUSION

Innovation can be the key to improving the bottom line in many organizations. But spending a lot of money on research and development may not necessarily be the best use of resources.

According to in-depth research conducted by Booz Allen Hamilton, money does not guarantee results, and companies need to take other factors and ideas into consideration. At times, major changes need to be made in several areas before innovation can thrive and help organizations realize positive economic results.

Based on the Human Capital Institute webcast, *Innovation in Financial Services*, of March 6, 2007

PRESENTER

Goran Hagegard,

Principal

Booz Allen Hamilton

Mr. Hagegard is a Principal with Booz Allen Hamilton based in the New York office. He focuses his work on operations strategy issues, with a special interest in innovation. He works across a broad range of industries including highly engineered products and services. Mr. Hagegard has served clients in the U.S. and in Europe where he has led and supported numerous strategy, operations as well as IT development engagements.

MODERATOR

Joy Kosta

As Director of Talent Development and Leadership Communities at The Human Capital Institute, Joy brings twenty-five years of experience in multiple facets of organizational development, human resources and business management with an emphasis in customer satisfaction, service quality, process improvement, and applying the Malcolm Baldrige Criteria for Performance Excellence. As founder and President of Performance Partners in Health Care, a company dedicated to building better patient experiences, she has authored several curriculums in leadership and staff development, and co-authored with Harold Bursztajn, MD Senior Clinical Faculty member, Harvard Medical School, *Building a Treatment Alliance with Patients and Families*.

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