LAWRENCE SOMERSET LIMITED

Issues discussed at the Innovation Forum Dinners

At previous discussions, we've covered the following topics:

• Is the financial services market really innovative?
• Is innovation a route to growth and business performance?
• Is there a need for disruptive innovation?
• What is the role of leadership?
• How should we consider the 'new' customer?
• How should Life companies reinvent themselves?
• How can companies ensure they capture the value they create?

If there are topics you would like to discuss, please let us know by sending an email to

forum@l-s-l.com

Here are notes based on the discussions…..

Is the financial services market really innovative?

An early question was whether there is much innovation at all in the financial services markets– compared with telecoms. for example, where there is a clear progression in technology of handsets, bandwidth and functionality, is it hard to draw out the parallels in the financial services markets?

There have been new products in most markets over the last 10-15 years - they often lack the tangibility of a new handset – but how many can remember queuing in a bank branch to get cash with a cheque, or being interviewed to see if a building society would deign to lend you money? A few further examples illustrate the point:

- Product line extensions – Capped rate mortgages, flexible and off set mortgages, home income plans, etc etc ;

- New products – debit cards, Index trackers, SIPP, WRAP, Stakeholder pensions, capital guaranteed products, hedge funds;

- New processes – On line banking, on line purchase of insurances, credit referencing, online underwriting;

- Extensions to existing business models – outsourcing, multi-manager/open architecture, securitisation, white labelling, packaging;

- New business models – First Direct, Direct Line and Egg, and more recently, funds supermarkets, WRAPs, ING Direct, Zopa.

- Serving previously underserved markets with existing or modified models – taking wealth management to the affluent, SIPPs moving down scale, credit businesses for near- and sub-prime

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Two additional factors were discussed which distinguish the financial services markets from others – the first is that there is typically a large group of existing customers whose 'products' do not confer tangible benefits on a frequent basis. For many, their financial services are 'out of sight out of mind', and this can seem to reduce the need for innovation. However, the churn and retention problems faced by many providers of mortgages, or endowment policies belie this view, and much more attention is now being focussed on retention.

The second factor is that the financial markets are cyclical – for example, housing prices boom, personal debt expands, the market collapses, bankruptcies and negative equity results, stock markets return, people make money - then lose it, housing starts to look attractive again…… .The effect of this is to make moribund products seem attractive second time around because the market is on an upturn, and because people have short memories. Again this can be seen to reduce the need for radical innovation. The need is to call the cycle correctly.

Is innovation a route to growth and business performance?

One would hope that the point of new products and services would be to gain market share, and build sustainable revenues, but it depends on the context and the type of innovation, and the real issue is, once share has been gained, whether it can be sustained.

Innovation which relies on a **scarce capability**, such as excellent fund management, or a distribution deal providing access to a flow of customers, can be defended. Other innovations that are just stand-alone good ideas, but which rely on a high cost base for delivery can frequently be copied by others with a similarly high cost base, and just result in short term gain and perhaps a shift in the market.

Disruptive innovations that change the landscape and the balance of power can create sustainable gains. Direct Line was one such case that transformed the sale and manufacture of personal lines insurance. Other firms who sought to follow had difficulty in building revenues and even more in reaching break even. This was achieved through a combination of reengineering the proposition, in this case through telephone access and service and underwriting and achieving lower cost delivery.

Funds supermarkets are another example of this – and because they represent a 'value chain' play, inserting themselves in the relationship between intermediaries and clients on one side and fund managers on the other, they are set to erode margins for many in the asset management business.

Some innovators have been able to address **markets that are not currently served** by the mainstream suppliers or by existing propositions. An example of an underserved market - Cattles and Provident Financial have built large businesses in the near-prime and sub-prime debt markets partly because the major lenders do not want the risk exposure. An example of a top end proposition being moved downmarket - growth in the SIPP market is expected to come from mass affluent pensions customers who have not previously had access to SIPPs at the costs and functionality now available.

Other innovations have not had the same positive impact .

Online banking has been a **service enhancement** for many institutions and may not have led to increased revenues or avoided any cost elsewhere in the business. In this respect it has been a necessary development but has not yielded relative advantage – except when there is the occasional security slip-up. Many similar innovations are taken as hygiene factors by customers and do not earn improved behaviours.

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Price based competition in the debt markets has had more of a mixed outcome. Margins are reduced from the customers who become educated to play the market. But some institutions seek to play the percentages on the customers who will stay on what can become a poor deal later on. More broadly, price-based competition has certainly led to some disruption – MBNA and other US firms have taken significant share from the traditional banks, especially Barclaycard, in the credit card market. This sector could now be ready for a major transformation – into a quasi-charge card business driven by service and arranged credit, and a credit using segment with closer integration with other debt vehicles, each segment served by different propositions and different suppliers.

Others try to look on price- or rate-based deals as a locus product and seek to 'cross-sell' other products and services which will make money, but this requires considerable skill in sales processes and insight into customer-based economics to be successful, both of which can be in short supply.

So some innovations can undoubtedly drive growth, but there must be a game plan, there must be a sustainable and non-replicable component to the innovation (at least for a while) for gains to be made and held, and this needs to be rooted in an understanding of customer behaviour, and the innovation likely needs to involve a low cost base.

Is there a need for disruptive innovation?

But how much appetite is there for disruptive growth – the sort that makes a long-lasting change in a sector?

A large proportion of an institution's current revenues will be from existing customers who 'bought' their product some years ago and who continue to 'use' it either as an explicit service or as an insurance cover against some future risk. If these revenues are seen as secure, the institution will not see a great need to disrupt markets, because this will involve disrupting existing customer relationships – possibly to a position of lower profit impact. In fact a great deal of energy goes in to **not** disturbing existing customers.

There are at least two reasons for taking disruption seriously.

First, someone else will do it for you. New entrants have a vested interest in disturbing client relationships, and this is most apparent with the new business models – entrants from foreign or adjacent markets may seek to disrupt a given market if they see the opportunity. Incumbents are then faced with the choice of disturbing the market themselves and pre-empting new competitors or hoping to defend in a more passive way.

Second, you may be forced to do it anyway. If market dynamics shift so you can no longer rely on retention, you may need to remake the business but it's harder to do reactively – witness the with profits business which should have reinvented itself 15 years ago, or the debt market, as demand slows, there will be increasing competition for existing clients form incumbents and intermediaries. An institution that is not prepared to innovate will lose clients

What is the role of leadership?

Leadership is crucial to any innovation programme, not only to provide the vision and commitment to a new direction but to ensure that the 'business as usual' processes and mindset do not kill off new ideas before they have been given a chance to deliver.

Few companies appear to have targets for new proposition development, for example the percentage of revenues to come from new lines of business. Many have growth ambitions, but these are often no rooted in specific initiatives. The most successful have broader objectives eg to grow shareholder value every 3 years, which encourage executives to use innovation as a necessary tool to be successful.

Personal ambitions may play an important role here. Why rock the boat by trying something innovative, but necessarily risky when the existing model can serve for another 3-5 years? But several leading firms want to outgrow the market – Standard Life, HBOS, Prudential and Barclays for example, and to do this they will need to do things differently.

One client put it to me that senior management have 'two masters' who between them encourage a focus on the near term. One master is the stock market analyst who demands market share. This can encourage firms to 'buy' new business without due regard for profitability. This is evident in the debt and savings markets, and historically in the cheque account market when free banking was introduced.

The other master is the 3 or 5 (or 1!) year plan that demands profits, and this can lead to tactics which disadvantage existing customers because they are often not paying attention. Examples are: rate creep on savings or credit products; undisclosed charges; penalties; or selling products of dubious value; all of which earn annuity revenues from the unsuspecting. A current debate on just this topic concerns the high returns (20%-30%) earned in the SME banking market that Don Cruickshank has been referring to recently based on practices such as prolonged clearing over which the customer has no alternative, and the difficulties for new entry.

This tension between these conflicting objectives inhibits innovation in product, service and customer experience to the extent that any innovation must carry the burden of an opportunity cost – the lost income from offering a sub-standard service to a trusting customer.

How should we consider the 'new' customer?

There was a suggestion that the new, younger customers of financial companies will behave differently from older cohorts, and that if new mores are emerging these will affect what financial services companies need to do in thinking about innovation.

One example of this might be found in the debt market – there appears to be a view that younger borrowers are not too fussed about repayment – and the new rules around bankruptcy will not help because bankruptcy becomes less of a stigma.
A broader point, perhaps is that customers are better informed, more cynical and more prepared to switch.

Four conclusions follow from this.

First, the locus of innovation should pass from the product to propositions and the customer experience.

The financial services industry does a good job with products, but a poor job at understanding customers and in being customer focussed. The reasons for this are partly historic – firms used to reflect their product history and individuals their basic professional training. Now many institutions are integrated across product markets but individuals retain their professional affiliations, and many institutions still contain individual business units with their legacy systems that are decidedly not yet integrated. Innovating customer propositions and customer experiences will require a more flexible approach.

The effect of shifting the focus to customer proposition can be profound – a proposition is much broader than a financial instrument and encompasses the whole benefit package on offer - sales and advice processes, service, information and communication. It also addresses the emotional needs of the client, not just the financial and functional.

Second, Institutions will need to move beyond segmentations that have been developed around attitudes and life-stage – because these are not likely to reflect sufficiently the new behaviours that will become apparent. Rather a closer observation of how customers negotiate their way through the complexity on offer will be required to influence their choices going forward. This will require better use of information, faster cycle times and better, more tailored responses.

Third, there must be a better link between what institutions think they do and what actually happens at branches and service centres. This is particularly important for those who have out sourced customer contact on cost grounds but who now are unable to lever the customer contact in creative ways. It is also important for firms that want to lever branch networks.

Fourth, there will need to be a better understanding of economics, particularly at the customer level, and particularly of costs for institutions to be able to make the right judgements. New mono line suppliers are well-placed here especially

How should Life companies reinvent themselves?

Since three of the participants at one dinner were from the insurance sector, we discussed the issues facing life companies.

Life companies have for many years been operating as investment management and savings institutions largely because of historic tax regimes and because of the with profits family of products. These firms were able to position themselves as a safe pair of hands for the mass market saver with a strong play on their ‘protection’ credentials and they benefited enormously from the growth in mortgage collateral vehicles, unit linking and the growth of the Hambro Life/Allied Dunbar/Abbey Life direct sales technologies which shifted them further towards pure investment. The landscape has now changed dramatically with the collapse of credibility of with profits bonuses.

The question for these firms is now how do they reinvent themselves? Do they abandon their past in protection and move whole-heartedly into investment, with the problems of competing as a manufacturer in markets dominated by access to customers? Or do they return to protection, with the more limited scope that implies? Or are there another options? Few firms appear to have a clear way through these questions – Legal and General is one such.

How should companies ensure they capture the value they create?

The introduction of an innovation implies the creation of new value. This value can emerge in many forms, for example: additional benefits for clients, better margins, improved access to market etc etc. The question is where does the value that is eventually created accumulate, and crucially, does the innovator benefit?

This discussion centered on the question of the dominance of the large banks on the retail markets and whether banks were especially advantaged with large transaction-oriented customer bases. We will explore other facets of the topic at other dinners.

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The top 5 banks now represent 65% of the capitalised value of the top 50 financial institutions listed on the FTSE, and this is likely to increase. What has this to do with innovation?

One perspective is that large banks do not need to innovate in a way that confers strategic advantage, they can merely hoover-up ideas created by others and scale them up by offering them to their own customers. Indeed many of the acquisitions and demutualisations of the last 10-15 years have been associated with acquiring new capabilities and innovations.

If this is the case, the second tier firms have a problem – how can they introduce innovations and capture the value created without it leaking to competitors, what should their strategy be?

The views on this were mixed. Some felt that there were lots of niches in any market, and that there are many opportunities for smaller firms to be creative in ways that the larger banks cannot copy. For example, products for divorcees, currency denominated mortgages, funding lines for professionals' clients, and so on – the sheer complexity of running large banks demands a level of simplification and uniformity in their approach, and they cannot expect to be at the cutting edge in every niche.

Moreover, there are many things smaller institutions can do that large banks would not wish to replicate – not because of complexity, but because of the opportunity cost. In many markets, there are underserved or over charged customers who do not attend to their financial affairs, and these customers represent an important source of profits to the large incumbents. Smaller or niche players can offer a proposition to these customers that it would cost the incumbent too much as they would need to make the offer to the whole customer group. In the SME market, for example, the share gains made by Alliance and Leicester and HBOS would have cost the incumbents too much to reverse by head-on competition. In the event this is what happened, but only because of the Competition Commission ruling, ie they did it because they had to, not because they wanted to. Identifying such opportunities should be part of any smaller firm's strategy

This view is reinforced by a consideration of the role of brand. Clearly the large banks are 'household' names in that they are well-known. But they are not always well-liked, and increasingly, our research shows that people do not want to put all their eggs in one basket. The large banks' strategy is based on a strong cross-selling premise, but this will only go so far. On the contrary, smaller institutions can create strong brands in niches, such as ING, which has created a strong brand positioning on the back of a single well-priced product.

On the other hand, banks do have pervasive relationships. Not only do they have well known brands, but they have frequent and important contact with most of their customers, if not daily, then certainly weekly. So their brands have a tangibility which is hard for an asset manager or insurer to replicate. The challenge appears to be how to lever this position to good effect. That is essentially an operational issue. One could suggest that even with a bland product set, the large banks' ability to cross-sell will be much enhanced if they are able to get staff in different bunkers to cooperate with each other.

Beyond this, there is the challenge of integrating acquisitions that have been made to access an innovative product set or market position. The track record of such moves has not been good and seldom does the acquired business continue to innovate.

Against the enormity of these tasks, generating cutting edge innovation in customer propositions may seem less of a priority than having customer contact and service strategies that further their cause. So for a large bank, a strategy of acquisition, arbitrage or just plain copying would appear to be viable against a well-thought out ability to execute.

The answer for any given firm and its approach to innovation probably lies between these two extremes and will differ by market.

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