

The Strategic Value of Growth and Innovation

- Grow profitable and faster than investors expect to get further investments.
- Create an international strong brand value as this is instrumental for global expansion.
- Develop a profound knowledge about the characteristics and intricacies of service innovations to render a coherent solution to clients.
- Link innovation and growth and put it on the leadership's agenda.

The Challenges of Growth

Understanding Growth

In biology, growth is the increase in size and mass during the development of an organism over a period. Growth is often measured as an increase in biomass (mass of organic material) associated with the differentiation of cells to perform specific functions. All organisms grow although the rate of growth varies over a lifetime. Typically, growth in an organism follows an S-shaped curve, in which growth is at first slow, then fast, then, toward the end of life, nonexistent. Growth may even be negative during the period before death. *Do we understand growth now?* Of course not. In general, we cannot adapt definitions from nature for our purposes. However, if we look closer to economic growth, we can detect similarities. Under economic growth, we understand the increase in value of the goods and services produced by an economy. As it is conventionally measured as the percent rate of increase in real gross domestic product (GDP), one may say that strong growth reflects an increase of the average standard of living of individuals in a country. Over the last years, we have observed a steady increase of wealthy people in the world. These so-called high-net-worth individuals (HNWI) control more and more wealth. This is directly reflected in the GDP and market capitalization of a country. In particular, market capitalizations in Asia and Latin America have grown rapidly driven by foreign investments, strong corporate profits, or IPO (Initial Public Offering) activity and accelerated wealth creation in those particular economies.

By doing the math, we know that over long periods of time, even small rates of annual growth can have large effects on economies. Hence, a growth rate of just 2.5% per annum will lead to a doubling of GDP within 28 years, whilst a growth rate of 8% per annum (experienced by some emerging markets) will lead to a doubling of GDP within 9 years. Eight percent growth is also required, e.g., for India just to cover the annual requirement for millions of new jobs and to be able to keep poverty under control. Global economic growth so far has been the strongest upswing since the 1960s. Obviously, growth is the key pillar of economic activity – and for countries like India a must.

But let us look at the financial markets as they have grown very aggressively since the 1980s and became much bigger and more powerful than entire economies. In fact, the total global financial assets including equities, government and corporate debt securities, and bank deposits were about equal to global GDP in 1980 but by 2005, the global capital market had grown to about three times world GDP, or US \$140 trillion and is expected to grow further to over US \$210 trillion by decade's end.¹ This has an enormous impact, especially for firms in the financial service industries. Through their fees, they generate revenues from the management of these assets. Where most people in the financial service industry think better liquidity and access to capital for borrowers as well as more efficient prices are generally good things, after all, a global pool of capital implies also threats. Strong growing global capital markets paint a picture of the world with high stock prices, low interest rates, and increased debt levels. In case of an exogenous event – slower economic growth or a recession, rising inflation and interest rates, oil prices spiking higher, geopolitical shocks, or war – this is doomed to failure and can get ugly in a big rush. To present a bad example of uncontrolled growth, just take the recent mortgage crisis. In the United States, about two-thirds of retail banking revenues in 2006 came from mortgages and consumer finance, where in Germany this segment contributed only about 5%. During the summer of 2007, it became painfully apparent that the enormous swell in household borrowing in the United States was largely responsible for the strong balance sheet growth of many retail banks. The examples demonstrate that growth varies by product segment as well as by a country's sociodemographic patterns.

Coming back from macroeconomics, most of us tend to attach a particular value to the annual percentage change, perhaps since it tells us what happens to our wage check. Where employees feel growth with salary increase, for businesses to survive, growth is an imperative, not an option. There are several answers to the ultimate question, *why growing?* Regardless whether we take the perspective from an economy or company, growth is important to maintain competitiveness. It is required to retain and increase market share. Growth also compensates increasing cost through economies of scale. If we look at growth as an increase in wealth, we see that the growth in assets under management of a wealth manager consists of roughly half from net inflows, which means new money that clients brought into the bank, and half through improvements in investment performance of existing assets.² The inflow of money can be referred to as *organic growth*. Any type of growth of a firm meets the increasing demands of all stakeholders of that organization. Shareholders, in particular, are interested in strong growth rates as it gives them

confidence to invest in the firm. This money is required for future investments such as innovations, increasing productivity, or business expansion. A firm that has been growing over years is more interesting for suppliers and customers either. Growth finally creates employment and contributes to an economy with prosperity.

The growth strategies of many banks during the last years have been striking. It was learned that growth is still vital, yet the patterns of growth changed. We should perceive sustainable growth via differentiation from competitors to superior product and service quality, customer satisfaction, and employee excellence. The key sources of competitive advantage are quality in products and services, customer service, sales branding, and marketing. In addition, growth strategy suggests that a business' attempts to grow depend on whether it markets new or existing products in new or existing markets. Thus, firms need to become more innovative when seeking ways to grow. This means applying new technology, product, service, process improvements, and human capital management. The message in a highly competitive global environment is simple – perform better than others. A good performance is reflected in the willingness of shareholders to invest in the company. But increasing total revenues alone is not enough. We simultaneously need to watch product and service profitability, customer profitability, and even employee profitability.

Profitability Drives Value Creation

Never forget that the bottom-line goal of every company is to create superior returns to shareholders. In today's dynamic and competitive environment where markets rise and fall over time, companies need to change rapidly, radically, and measurably. Financial markets relentlessly pressure top executives to grow and keep growing faster and globally. To deliver a rate of return to shareholders in the future that exceeds the risk-adjusted market average firms must grow faster than their investors expect. Simplified, its stock price can only be prevented from falling if the rate of growth exceeds the forecast and if the growth is profitable. The price per share divided by the earnings per share, known as *P/E ratio* or *multiple*, is a good performance measure of success and reliable sign of whether a firm is winning or losing. The P/E ratio serves as an indicator of business problems and opportunities. By relating price and earnings per share for a company, one can analyze the market's valuation of a company's shares relative to the wealth the company is actually creating. Therefore, it is important to understand why a premium P/E, one that is higher than the overall market's average, is imperative. For example, if one stock has a P/E twice that of another stock, it is probably a less attractive investment. But comparisons between industries, between countries, and between time periods are dangerous. To have faith in a comparison of P/E ratios, you should be comparing comparable stocks. Historically, the average P/E ratio in the private banking market has been around 15, compared with 10–12 for retail and universal banks. In the banking industry, the ratio has always been much lower than for the high-tech industry. The financial service institutes currently make up the bulk of P/E lists

as a result of the financial crisis. We saw market valuations of far below ten for a number of giant banks. In a normal market environment this would mean that these stocks are inexpensive as compared to its earnings and hence a good investment. The problem though is the uncertainty of the future of many institutes. There are few reasons a stock has a high P/E ratio. For example, Google exceeded a P/E ratio of 100 during the summer of 2005. This is typical for companies that have not made much money yet but expect to do so within the next quarters or years. Here, the market expects the earnings to rise rapidly in the future. In contrast, a high P/E ratio can also be explained with the fact that the company was previously making a lot of money, but in the last quarter or year, it had a special one-time expense. This so-called *charge* lowered the earnings significantly. However, stockholders usually understand that this was a one-time issue and will still buy stock at the same price as before, and only sell at least that same price. Also note that a specific stock may have a temporarily high price when, for whatever reason, there has been high demand for it. This demand may have nothing to do with the company itself, but may rather relate to, e.g., an institutional investor trying to diversify out risk. These are just a few reasons that affect P/E ratios.

To show that the earnings in P/E do not bias us, let us show that we are well aware of that issue. Finance experts explain the multiple with *nongrowth* and *growth* elements. The so-called nongrowth element indicates that much of the P/E comes from the firm's performance at present. This means the firm performs exactly as it did last years, every year in the future. In that case, the nongrowth element would constitute its entire P/E. In contrast, the growth element reflects the market's expectations for the firm's profitable future investment opportunities. It will give investors good reasons to expect significant performance in the future; hence, that is where nearly all the opportunity lies. In fact, just four factors determine whether the growth element of a firm's P/E is large, moderate, low, or even negative. It is crucial to understand that any action a manager takes to increase the share price and the P/E must come down to affecting one of those factors. Firstly, the *return on invested capital* together with the *capital cost* measures the true profitability of future investment opportunities. This financial measure simply quantifies how well an organization generates cash flow relative to the capital it has invested in its business. In particular, the difference between the above-mentioned variables, the *spread*, is a good indicator for investors to see the forecast of a firm. Secondly, the *investment*, the amount of money a firm invests back into its businesses in excess of depreciation and amortization each year, is another strong growth lever in pushing the P/E up or down. To achieve respectable growth, investments must be at least enough to maintain the business's assets, better it should be greater of what is required to cover depreciation. Lastly, there is the *duration*, the length of time a firm is able to maintain returns on new investments in excess of capital cost. Of course, a firm can arrive at any given P/E through different combinations of the four factors. One thing is for sure, firms with a P/E ratio above market average will be the winners in the competition to attract capital. They will not only best be able to satisfy shareholders by investing their capital for sustainable growth, but also to hire best people and serve customers.

Though this sounds logical, study after study confirms that roughly 90% of all publicly traded companies in developed economies have proved themselves unable to sustain for more than a decade a growth trajectory that creates above-average shareholder returns. Christensen and Raynor discussed in their book “The innovators solution” this growth paradox.³ Based on their own research and a number of studies, they concluded that growth and innovation is interdependent. The failure to consistent, persistent growth is not due to lack of great ideas, unpredictable innovations, or capable managers, nor is it because of the changing nature of demand and erratic customer behavior. Sustainable growth fails because companies unwittingly strip the disruptive potential from innovations before they ever see the light of the day. Besides this, companies need to be profitable. The question though is, *what drives value creation?*

The Levers of Value Creation

A study by the Boston Consulting Group in 2005 explains that although the top 20 global banks have focused on effectiveness by increasing their average return on equity (ROE) to about 17% over 2005, most are struggling to maintain its efficiency with cost-income ratios (CIR) below 45%.⁴ Despite the fact that banks have reached high levels of profitability until 2005 compared to other industries, they have to be aware that pure efficiency gains have limits. One may say that increasing operational efficiency is less difficult to undertake than growth because growth exposes an organization to greater risk and an increased need for the innovation. Thus, growth not profitability drives size of market capitalizations. Accordingly, profitability seems to be a prerequisite for value creation and a strong driver for total shareholder return when starting at a low level. Profitability increases from high levels add only limited additional value with ROE converge at 15% for banks above the US \$20 billion market capitalization level. In addition, if we look at empirical cost-income ratios, only banks with market capitalizations below US \$20 billion achieved regularly ratios below 45%. The reason for that is that increasing complexity and variety of large firms account for efficiency constraints. Although the conclusion of the study sounds logical, we argue that growth alone is not always positive. By looking back to our biology example, not everything that strengthens is commendable as one can grow by gaining fat. The point we want to make is that growth must show muscles, because only through growing muscles one is gaining strength. Just translate this to economy and you understand what we mean by profitable (healthy) growth.

The third factor that we have to consider if we want growth and profitability to sustain is *risk*. The notion of risk is independent of the notion of growth and profitability. In financial markets, we measure credit risks, the risk of loss due to a debtor's insolvency. For financial investments, there are a large number of financial instruments to mitigate risks. *Hedging*, for instance, means that a specific financial instrument is purchased to reduce the risk in another financial product. Many financial risks can be hedged with sophisticated products. However, we

cannot describe all the risk categories within the context of this book but there are many more such as consumer credit risk, interest rate risk, liquidity risk, volatility risk, currency risk, or equity, all with dedicated models and scenarios for monitoring. Risk in business is a reality and has to be considered, especially during strong growth periods, though some risks are difficult to manage. In particular, financial institutes that act as intermediary are confronted with various risk categories that are interdependent. The subprime mortgage collapse has intensified interest in risk management. The deregulation of the banking industry led to irresponsible homebuyers and predatory lending practices with increasing complexity of financial instruments. We are confident that our oversimplification exemplifies the importance of risk management. To improve growth and profitability while successfully managing risk, it is important to leverage synergy of people, processes, and strategy. Thus, appropriate organizational and technological architectures help to mobilize the workforce to pursue ambitious targets with their full commitment in line with risk management measures. This is born out of a culture that sees performance as a value and relies on outstanding leadership. As we discuss later on in this book, a trust-based open innovation culture is thus essential to unleash the forces of innovation and growth. Although we must never neglect consistent financial risk analyses, to assure profitable sustained growth the management has primarily to focus on innovation. And, the innovations that can satisfy stockholders demands for growth require taking risks. To succeed with this mandate, we need to understand the forces that shape innovation, in particular that act upon the individuals involved in creating innovation and new growth businesses. Mastering change, innovation, and growth, while keeping track of costs and risks, is challenging. The impact of profitability and growth on value creation, however, varies between big and small companies, industries, and countries. Therefore, we must better understand key growth strategies and actions that drive success inside the vast area of innovation. This confirms the theory that growth can be undertaken through mergers and acquisitions, alliances, joint ventures, outsourcing, corporate venturing but also organically.

In Pursuit of Profitable Growth

For the assessment of profitable growth, we need to relate value and profitability. Ratios such as revenue and income as well as net margin and asset growth are indicators that show the real top performers. Often, top performers calculate the economic profitability of every one of its customers on a monthly basis. Such stringent performance management helps them to spot where to improve value propositions for existing clients and to identify clients that they should try to acquire. But it also maintains risk management. Essential here is to shift the mindset and understand that not every product per se must be profitable rather every client relationship or relationship with a group of clients.

Almost none of the top wealth managers represent high profitable growth. Certainly, many wealth managers steadily increase their assets under management but if we take a closer look, we see only few banks having the capacity to increase the asset under management net margin (profit over asset under management), while growing their asset base. One might say that growth can only be achieved if acquisitions are part of the strategy. On the other hand, organic growth is necessary likewise. Regardless the strategy, how to build on profitability should always be considered. Organic growth might be an option if there is no other company in the banking business to acquire or merge with. Growing organically in mature markets and making successful acquisitions in markets with strong growth rates might be thoughtful. If we look to Asia and Eastern Europe, the rise in business confidence during the last 5 years has increased the level of merger and acquisition activity. Deeper analyses demonstrate that this new wave of restructuring in financial services is different from the transactions of the 1980s and 1990s. It is likely to be characterized by alternatives in alliances, joint ventures, and outsourcing as well as innovation where straightforward mergers and acquisitions may not be the way ahead. However, growing through acquisitions has always been an option for increasing scale and geographic diversity. In June 2006, Axa, the French insurance and asset management group, unveiled the purchase of Winterthur, a European insurer, from Credit Suisse for CHF 12.3 billion. According to Henri de Castries, Group CEO of Axa, this transaction is merely a unique opportunity to reinforce their leading position in core European markets and increase their presence in emerging markets, notably in Eastern Europe and Asia. Winterthur, the Swiss-based company, serves 13 million clients in 17 countries with a mix of life, property and casualty, and pension products. This deal helps not only to quench Axa's thirst for growth, what is more it is part of the strategy to double sales and triple the profits by 2012.

Radical blockbuster mergers and acquisitions in the range over US \$50 billion of huge institutions as we have seen at the merger of JP Morgan Chase and Bank One in July 2004 or Bank of America and Fleet Boston in 2003 may be of questionable value. The recent takeover proposal for ABN Amro by the Royal Bank of Scotland of about US \$90 billion was even the largest in banking history and the third biggest over all industries. Although history evidenced that half of the deals failed to create their expected value – some even destroyed value, there still seems to be optimism that synergy opportunity exceeds integration costs. In particular, crossborder deals have been disappointing compared to domestic merger and acquisitions. So synergies are often not available if banks from different countries merge. The same applies to crossborder acquisitions. The explanation for many failures in crossborder transactions are the increasing complexity of regulatory issues, politically obstacles, compliance with government, cultural differences, in addition to stakeholder expectations that change faster today than 20 years ago. We saw firms where more resources went into consolidation and integration than into growth. Postmerger integration involves massive change in terms of restructuring. Therefore, the top management must consider crossborder acquisitions more carefully and should do it only if they have the capacity to run the business well.

Strengthening the Domestic Platform Before Going Global

At a global level, during the 1980s and 1990s, the economic rationale for mergers and acquisitions was conclusively. Increased cost bases favored larger, consolidated players seeking synergies between the acquirer and acquired firm. But even today, we should not neglect the potential of having cost synergies beyond the traditional 10%. Although a primary type of deal puts economies of scale first, modern consolidated players are seeking to expand market share and increase their product and service capabilities. Certainly, there are still acquisitions driven by pure cost considerations as the acquisition of Abbey National, the English retail bank by Banco Santander, the biggest Spanish bank, in 2005 evidenced. The overall goal was to reduce Abbey's cost base by 20%. Consolidation has accelerated in recent years but the rationale for acquisitions has changed. Thus, one reason is that most assets that private banks seek are not new assets, but are already being managed by competitors. Consequently, aggressive growth strategies to capture wealth creation worldwide require acquisitions. Regardless whether we consider costs, growth, or a combination of both, resources are always a crucial issue.

According to the resource-based view of the firm,⁵ every company is a collection of unique resources and capabilities that provide the basis for its strategy and the primary source of its returns. To grow organically, a firm would have to acquire resources in the form of inputs such as capital, equipment, knowledge, and people, independently in the new market. In addition, the expanding firm would require new capabilities, conceptualized as the capacity for a set of resources to perform a task or action, which would not be available within the organization. Therefore, individual resources would not increase the firm's competitiveness. To form competitive advantage, synergistic combination, and integration of sets of resources is indispensable. It is ascertained that, e.g., global banks cannot rely on organic growth if they want to be leading wealth managers. On the other hand, established midtier private banks should strengthen its domestic position before expanding globally. There are some banks that credibly claim to be a top 20 wealth manager, but a closer look often reveals that this is the result of very profitable domestic businesses. Universal banks such as Bank of America, Citigroup, JP Morgan Chase, Wells Fargo, HSBC, Royal Bank of Scotland, ABN Amro, or BNP Paribas earn on average 70% of their revenues from their respective home retail markets. The large-scale domestic consolidation in European markets such as the United Kingdom, Italy, Germany, France, Spain, or Switzerland shows a similar picture than in the United States where a number of players have a global presence that is weaker than it is at home. Evidence suggests that leading players have established and grown their wealth management franchise by scaling up their international private banking operations from their home market.

The lack of organic growth forces these institutes for acquisitions. To take this assumption up, we suggest restructuring as a key investment theme for successful acquisitions. Over time there have become fewer and fewer true merger and acquisition stories within the banking industry. While many banks offer restructuring potential, we

would like to elaborate the levers of a strong domestic position for profitable growth further with the acquisition and restructuring story of Julius Baer.

Acquisition and Restructuring Comes Down to Management

Julius Baer that roots date back to the nineteenth century has become the third largest Swiss wealth manager (behind UBS and Credit Suisse) following the acquisition of the independent private banks Ferrier Lullin, Ehinger Armand von Ernst, Banca di Lugano, and the asset management business GAM (Global Asset Management) from UBS, for a total price of about CHF 6 billion in September 2005. Although, Julius Baer operates on the fields of private banking and asset management for private and institutional clients, similar patterns apply as for universal banks. A decisively client-centric approach as well as premium investment products combined with comprehensive investment expertise is the strengths of Julius Baer. With more than 4,200 employees in over 30 locations worldwide, the Group managed assets amounting to CHF 364 billion as of June 30, 2008.

Bankers have questioned the high price for purchasing the private banks as an unofficial rule, say that usually not more than 2.5% of the asset under management of the acquired institute should be paid. According to this practice, Julius Baer should not have paid more than CHF 5 billion. Raymond J. Baer, the president of the board, justified the high price with that they bought more than just assets under management. Accordingly, the deal includes intangible value. In particular, the acquisition of GAM provided the bank with access to superior investment products for its clients. Although the management believes that the new Julius Baer Group is more than the sum of its parts, we put the gains in relation to the net margin (income divided by the average assets under management) to show that the deal, at least at the time being, reduced the bank's profitability. Besides this calculation, the deal implied several other challenges. The two most important risks we need to understand are the bank's gearing to financial markets and the fact that no acquisition goes entirely smoothly. In addition to the mentioned risks, there are usually other elements of uncertainty occurring in acquisitions. This means you can never be sure whether the management team does get along or whether relationship managers of the private bank leave following the integration. From experience, we know that in private banking acquisitions, an average of 10% of a target's client base is lost in the first year following the transaction. Only if a deal has no client overlap, you can assume that there will be no lost assets under management. Another contentious issue is always the taking of client assets from a relationship manager. This typically happens when two relationship managers are servicing the same client. At Julius Baer, there was luckily no overlap among the client bases of the acquired firms and Julius Baer. Regarding the management team, we have seen within the banking industry that excellent management teams are able to overdeliver when it comes to restructuring. In particular, the relationship and collaboration of the key positions, in our case that of

the CEO and the heads of private banking and asset management, can really boost a share price through a successful restructuring.

Overall, the upside potential outweighed the risks and has made Julius Baer a true restructuring story. The deal doubled the bank's assets under management and gained synergies including revenues from cross-selling GAM products. In addition, the private banking business increased its gross margin by selling in more hedge fund⁶ products. What is striking though is that two years after the date of the acquisition announcement, Julius Baer has positioned its brand as a truly dedicated global wealth manager. Julius Baer's clear strategy and business model that focuses on managing wealth for HNWI can be seen as competitor advantage. Thus, there is no direct exposure to the subprime mortgage market. The bank's full dedication to view their clients at the center, rather than capital market debtors, is what wealthy clients actually expect from their private bank.

How to Become the Largest Wealth Manager in Just 10 Years

The case of UBS evidences that organic growth and growth by mergers and acquisitions should be complementary strategies. Irrespective of the problems UBS is currently facing as an integrated bank, we decided to elaborate its growth strategy by emphasizing on the bank's wealth management division. All of the firms that make up today's UBS Group look back on a long and illustrious history. The two Swiss predecessor banks, Union Bank of Switzerland (UBS) and Swiss Bank Corporation (SBC), came into being in the nineteenth century. In the late 1980s, neither of UBS' Swiss antecedents were prominent outside its domestic market, nor did either rank among the top 20 global banks. In Switzerland though, both were well positioned. Measured by balance sheet size, their combined market share reached as high as 50%. In the early 1990s, the two Swiss banks were commercial banks operating mainly out of Switzerland. It is in the past decade that the current identity of UBS began to take concrete shape.

The two banks shared a similar vision, namely to become a world leader in wealth management and a global bulge-bracket investment bank with a strong position in global asset management, while remaining an important commercial and retail bank in Switzerland. Union Bank of Switzerland, the largest and best-capitalized Swiss bank, opted to pursue a strategy of organic growth, or expansion by internal means without any growth from takeovers, mergers, and acquisitions. In contrast, SBC, then the third-largest Swiss bank, decided to take another route by starting a joint venture with O'Connor & Associates, a leading US derivatives firm that was fully acquired by SBC in 1992. O'Connor was noted for its young, dynamic, and innovative culture, its meritocracy, and team orientation. It brought SBC state-of-the-art risk management and derivatives technology. In 1994, SBC acquired Brinson Partners – one of the leading US-based institutional asset management firms. Both the O'Connor and Brinson deal represented fundamental steps in the development of the firm's products and processes. The next major steps followed in 1995, when

SBC merged with SG Warburg, the British merchant bank, and the old-established investment bank Dillon Read, New York in 1997. The deals helped to fill SBC's strategic gaps in corporate finance, brokerage, research, and investment banking business in the United States. Most importantly, it brought with it an institutional client franchise, which is still at the core of today's equities business.

The merger of Swiss Bank Corporation and Union Bank of Switzerland in 1998 brought together these two leading Swiss financial institutions, creating the world leader in private banking and improving the new firm's chances of becoming a complete investment bank, not to mention providing it with greater capital strength. The Boards decided that the new leading global financial services group would operate under the name of UBS Group. The rationale for this merger was that ongoing globalization and deregulation of the international financial markets, tougher global competition, and the resulting worldwide wave of consolidation in the financial service industry have made size an increasingly critical factor for any financial service provider with ambitions to be amongst the most successful players worldwide. Nevertheless, there was still a major item left on the firm's broader strategic agenda. It needed to garner a significant presence in the key US market to be fully credible as a truly global player in investment banking and wealth management. That was achieved when PaineWebber became a part of the UBS Group in 2000. The advent of PaineWebber dramatically changed the demographic and cultural balance of UBS. Before the deal, UBS was still essentially Swiss, with two-thirds of its almost 50,000 staff based on its home country. At the end of 2007, we count just one-third Swiss employees out of its 84,000 employees. As a measure of its success in creating a truly global firm, UBS now earns the greater share of its operating income outside Switzerland. The bank's workforce is distributed globally, with a very sizeable presence of 32,000 people in one of the world's largest financial market, the United States.

Since the merger in 1998, UBS has made enormous progress in all its strategic markets. In doing so, it has reaped the rewards of the transformation that started in the late 1980s. Within its growth strategy, the bank has incorporated a number of wealth managers into a single integrated global firm with a common set of aspirations and values. Within its European wealth management initiative, the bank acquired since 2004 Lloyds (France), Merrill Lynch (Germany), Laing & Cruickshank and Scott Goodman Harris both in the United Kingdom, American Express Bank (Luxembourg), Sauerborn Trust (Germany), and Etra SIM (Italy). Further, overseas acquisitions included Dresdner Bank (Latin America), Julius Baer (North America), Piper Jaffray and McDonald Investments in the United States, Banco Pactual (Brazil), Caisse Centrale de Réescompte Group from Commerzbank (France), and VermogensGroep (Netherlands). These additions have helped UBS to expand its international wealth management presence significantly, added clients, and increased invested assets. Although UBS has flourished over the past 20 years due to beneficial conditions such as the combination of low interest rates, booming asset markets, and rising demand for credit, the results from the case suggest that strength can only be sustained if a firm continuously develops the ability to adapt to changing conditions and understands how to manage its risks.

Between the end of 2004 and the end of 2007, UBS' balance sheet increased by more than 40%, with UBS Global Wealth Management and Business Banking reporting invested assets under management of more than CHF 2.3 trillion. In little more than a decade, UBS became the world's largest wealth manager with a market share of invested assets of around 3.5%. However, in little more than 1 year, since summer 2007, the subprime crisis is giving way to disastrous value destruction for the brand. UBS has become the most mauled European financial player in the global credit crisis with about CHF 50 billions in subprime- and mortgage-related writedowns. The underestimation of risks not only clouds the investment banking's future, rather it could also hurt UBS' core wealth management business.

Regardless whether a company is merging or acquiring to achieve top line revenue growth, it needs stringent risk management and long-term strategies of enhancing shareholder value once the transition is completed, and initial and obvious savings have been made. Through the process of acquisitions, a firm must remain focused on building an integrated business and an open innovation culture that is shared by all business groups – both essential ingredients for a continued success of any firm. The example of UBS that bought over 30 institutes in the last 6 years or HSBC with over 60 smaller acquisitions shows that the consolidation process and merger endgame are not finished yet. The consolidation that has taken place in the banking industry since the beginning of the century is a strategic response to globalization and reflects a business background, demanding greater competitiveness and efficiency. Consolidation is an economic and cost imperative rather than an operational necessity. Most institutes have been engaged in a battle to establish and strengthen supremacy in an increasingly competitive market. The consolidation of their resources with their competitors plays an important role in coping with increasing growth and profitability expectations of their shareholders. The recent crisis may even amplify the process of consolidation as some institutes are hit so hard that they have to sell their profitable businesses to comply with the regulatory capital requirements.⁷

The strategic value of growth is based upon a complementary strategy that balances organic growth and growth by acquisition, and that depends on aligning everyone and everything around a single set of corporate goals. Not to forget the stringent risk management that banks must not neglect in the pursuit of growth. However, growth can be achieved by looking at business opportunities along several dimensions. It is suggested that companies develop their growth strategies based not only on core competencies but also on assets that are hard to replicate by competitors. In particular, for geographical expansion, as one of the most powerful options for growth, local expertise in the form of relationship capital is a crucial success factors.

Global Expansion Strategies

Embracing opportunities in new markets is one promising strategy to grow. Firms compete aggressively to grow at above market average and capture a disproportionate share of net new asset growth. There are two ways of doing business, namely by

accessing markets through local operations domestically (onshore) or internationally (offshore). Offshore means that the firm does business out of its jurisdiction and tax domicile. Where some simplify offshore banking with tax optimization, others justify it with that there are many places in the world where people are uncomfortable with the political, economical, and social context. In these countries, wealthy people wish to invest their money outside the country. There is no common sense whether offshore banking remains significant or whether it decreases in importance. However, emerging hubs in Singapore or Eastern Europe may replace traditional offshore hubs such as Switzerland in the near future. Even so, there is tendency that the onshore model is replacing the traditional offshore private banking model gradually as the regulatory environment is developing and getting more sophisticated.

One strategy of global banks is expanding their wealth management franchise to emerging markets, predominantly to markets such as Brazil, Russia, India, and China (BRIC), Eastern Europe, or the commodity-driven Middle East. This makes sense, as in particular, the BRIC markets have in common that there is almost unlimited workforce, massive potential of consumers, and high gross domestic product growth. In addition, the three billion people have an optimal age pyramid. If we look at emerging markets' economic performance, innovations, use in technology, or education, we have to acknowledge their progress and classify many of them as emerged. Even though, there are other factors such as human welfare and rights or political stability that setback their growth. However, the development, driven by globalization, open, and free trade over the past two decades, is now entering a new stage as the next wave of developing economies is welcomed into the fold. Visionary leaders should thus assess early-stage investment opportunities in so-called "frontier markets." These economies are not yet developed enough to be called "emerging markets" but will become the next emerging markets. This is part of a natural progression as today's emerging markets are considered as developed with already fierce competition. To name some of these economies, we would like to refer to the Morgan Stanley Capital International (MSCI) recently published index of 19 frontier markets: Bulgaria, Croatia, Estonia, Kazakhstan, Romania, Slovenia, Ukraine, Kenya, Mauritius, Nigeria, Tunisia, Bahrain, Kuwait, Oman, Qatar, United Arab Emirates, Lebanon, Sri Lanka, and Vietnam.⁸ For all – emerging and in particular frontier markets – expanding domestic franchises comes with a high proportion of incalculable risk. It is a capital-intensive route and therefore pursued especially by larger firms that have the capacity to get over a loss-making investment.

The other route to grow is focusing on mature Continental European and US markets, which are effectively the world's largest wealth management markets. These markets require regional organization that is already provided by a number of established firms. Because clients in these markets increasingly want to be able to call on financial expertise close to home, many banks attempt to strengthen their international presence essentially with local footprints. The problem is that there are barriers to entry. For instance, building up a distribution network in international onshore countries with internal resources (organically) may be dissatisfying. A lack of deep and interpersonal relationships with local businesses and contacts to governments in these new markets entails increased management complexity and risks. Local rivals

have developed strong ties to a number of stakeholders over years that yield trust in business partnerships and trust and recognition of customers in the bank. Relationships are a valuable resource and cannot be duplicated for historical and political reasons.

Let us briefly illustrate the current challenges with the failure of Citigroup in the German market. Citigroup just copied regional rivals in Germany like Deutsche Bank. Accordingly, Citi's onshore banks were weak and margins were squeezed by competing genuine national banks that have stronger social capital. As a result of the underestimation of culture together with increasing subprime losses, Citi sold its German banking operations in July 2008 to Crédit Mutuel of France for US \$7.7 billion. The future will show whether Crédit Mutuel is able to integrate the 340 branches and satisfy the 3.3 million customers in Germany. Similar was experienced by Merrill Lynch, which illustrates that implementing an onshore strategy is not without difficulties. Relationship managers thought that they could be what they were in the United States to clients in Europe, but it quickly became apparent that it is not easy to go head to head against the heavily entrenched and powerful domestic banks. The increasing pressure on multinational firms to become *local* is clearly one of the major challenges of globalization. Certainly, there are also success stories. The unofficial best-in-class in geographic coverage is HSBC – “The global local bank.” The trend of the onshore model has played to the group's strength of solid domestic franchises. The bank has been busy expanding in emerging markets – also with investments into local financial institutes. The bank that was born in China in 1865 by the Scotsman Thomas Sutherland and a group of international traders who founded the Hong Kong and Shanghai Banking Corporation to finance trade between China and Europe is returning there. It became the first foreign bank to open a rural branch in China with today more than 60 retail outlets. Similar to other global firms, HSBC is standardizing processes, technology, and management information systems to leverage global scale. At the same time, they accept private banking as a local business where they position themselves as a natural competitor to the Swiss alternative.

For this time, let us just analyze the wealth management businesses as most banks in Europe have had a rather conservative approach to investment banking, knowing that it is hard to beat the top Wall Street investment banks. Ironically, HSBC's penchant for being local is partly why it did not come out of the subprime meltdown untouched. We observed that wealth management firms have made a number of acquisitions in Europe to attract clients in the United Kingdom, Italy, Germany, France, and Spain. As previously indicated, these countries account for ~80% of potential wealth investments in Europe.

Why Size Matters

We have to face that in a global business environment, size matters in the pursuit of growth. To focus on future challenges such as international growth, firms need to be able to invest abroad. Size gives them the identity, positioning, and power to invest in the expansion of international businesses. Critical size in growth markets

ensuring local knowledge and proximity combined with traditional private banking culture and entrepreneurial spirit is vital. We believe that in the future of banking, size is bound to play an even bigger role. It is clear that only a big bank is going to have the money and power to operate globally. To be recognized as an active player in the ongoing consolidation process, wealth managers need to have a critical mass of at least US \$70 billion client assets managed. Institutes with such volumes include much know-how and are able to develop more innovative products and services and distribute them globally on various channels. This gives them the capacity to provide a demanding and sophisticated clientele with local tailor-made solutions.

In a service industry, the advantages of economies of scale are unarguable. Banking is not like selling computer software, where you can distribute thousands of copies for quite the same high price per unit. In contrast to such service industries, it is rather labor intensive. Certainly, the more client assets the institute manages, the greater the deals it gets from suppliers. Alternatively, if a client advisor manages 1,000 accounts instead of 300, he or she is usually paid the same salary. In spite of these mechanisms, we must not forget that in particular in private banking customers expect an individual and intensive care. Another advantage of firms with a strong international franchise is that they have the capacity to subsidize their international growth initiatives with other lucrative businesses.

As discussed so far, there is certainly every motivation for banks to consolidate. Besides the importance of size and growth, acquisitions, on the other hand, import risks and a large organization. Although there are forces that support size, scale, and global reach, large companies may imply a need for bureaucratically led rigid organizational structures. The challenge is to capture the benefits of growth, while at the same time staying alert, agile, entrepreneurial, client-centric, and global in thinking. This kind of business model implies a management style, which reinforces values of partnership, of collegiality and of teamwork. In general, companies should only be open for acquisitions, as long as the potential acquisitions meet the firm's specific hurdles. These include strategic fit, cultural fit, financial attractiveness and, most important, outweigh the benefit of repurchasing the firm's own shares.

Usually, banks with less aggressive international growth strategies focus on their home market. This becomes apparent if we look at Switzerland, which is one of the three largest wealth management markets (after the United States and United Kingdom) with assets under management of US \$6.4 trillion as of the end of 2007. This accounts to about a tenth of the world's total assets under management. Switzerland is acknowledged as home base for private banking and is to remain a key pillar. Swiss private banks are traditional and respectable institutions. The service quality provided is not something that can easily be copied by competitors or adapted to other markets. Focusing on the domestic market and benefiting from size in Switzerland, as smaller banks may seek to sell out, might be an opportunity instead of taking risks abroad. One could say that smaller and specialized wealth managers, headquartered in Switzerland, have no need for global expansion. The consolidation in the industry tells a story closer to the Julius Baer case, where they strengthen their business in Switzerland and use the strong domestic position as hub for global expansion.

Competitive Positioning

Top performers have learned from own experience and watching the market. They know exactly how to activate the levers of asset pool sizes and growth rates to generate value. Their strategy is to simultaneously grow organically, make acquisitions, and improve performance and capital allocation. The firm's capacity to access asset pools and extract sufficient value through the right distribution model is as important as managing a business portfolio. Latter means to establish growth platforms by acquiring small local players to build complementary capabilities and then leveraging own knowledge. Overall aim should be pushing profitability above cost of equity. This strategy to value creation has been recently evidenced at a number of large players. Usually, the logic of shareholder value-oriented firm is to grow and then return capital to shareholders. In fact, in the absence of the need to finance acquisitions, a firm can choose to return excess capital to shareholders by buying back its own shares. This form of optimizing the firm's capital allocation by returning it to their shareholder is what keeps them investing. Consequently, equity will further decrease and earnings per share increase with a relatively constant market capitalization.

To grow and thrive on competition, governments and regulators are jointly responsible. They are asked to advance and push the competitiveness of their financial centers. A strong and efficient financial industry is ultimately hiking a country's economic growth. To see the connection, just look at Germany's once impressive Deutsche Bank. Twenty years ago, Deutsche Bank was Europe's largest bank. It has gradually lost competitive edge and is today, ranked by market value, hardly a top 10 bank, far behind banks from the United Kingdom or rising French and Swiss giants, not to mention the Chinese banks that are currently the largest in the world. Even new competitors from Italy and Spain – products of banking privatization and deregulation – are threatening Germany's financial industry. The reasons for the new economic dynamism can be explained with deregulation and consolidation throughout Europe that has created profitable banking conglomerates. This is in contrast to Germany where banks hovered along, frozen out of two-thirds of their own home market by some 450 inflexible public banks and additional over 1,500 other financial institutes. A coalition of politicians has managed to fend off deregulation and globalization, but the price for the unwillingness to change and open markets is high.

Learning to Grow with a Chief Growth Officer

Corporate performance over the long term indicates that growth is the most important driver of value in the capital markets. The dilemma, though, is not to let short-term goals undermine sustainable growth strategies. To oversatisfy analysts expectations short term, chief financial officers are tempted to hold back on discretionary, spending such as research and development for product and service innovations or advertising and marketing if they were in danger of missing quarterly profit

numbers. We learned that a more disciplined approach to growth is needed, in which short-term financial pressure should not undermine initiatives that will pay off in the longer term. To make this clear, underinvestment in growth does never pay off, as it would impair a firm's products, services, and brand. Therefore, we strongly suggest detaching the financial authority from taking growth and innovation decisions and adding a new box on the organizational chart with the mandate to develop the right structure, conduct, capabilities, and culture for growth.

Although growth has recently risen to the top of corporate agenda, just a few firms installed dedicated functions that are determined to become true growth leaders. However, some forward-looking firms have realized the importance and have carved out a new executive position. This so-called *chief growth officer* supports the chief executive officer (CEO), as most CEOs are experienced in assessing people and organizations rather than ideas. The first reaction to that new role, coming from manufacturing firms of the United States, might be mild, especially in Europe and the rest of the world but a closer look shows potential. The main purpose of the chief growth officer is to identify and target new global growth initiatives and to deliver profitable growth by creating substantial platforms for businesses on that the firm can grow. Besides the responsibility to find value-enhancing revenue opportunities, he or she acts as a role model for sustainable and profitable growth. The chief growth officer is a portfolio manager and in charge of prioritizing the firm's short-term and long-term opportunities. Therefore, he or she must oversee sales, marketing, technology, product and service development, and new business ventures with focus on the most promising growth initiatives, and weed out the least profitable ones. This requires not only extensive line experience with operating responsibility, but also good diplomatic and negotiation skills as financial executives and risk manager will always challenge growth strategies. What separates growth leaders from their peers is the ability to create better organizational capabilities and a sustainable supportive culture. In such culture, the team is greater than single ideas. The team evolves an idea based on what it learns about customers, opportunities, and capabilities and brings it as fully fledged proposal through the chief growth officer to the top management of the firm.

In November 2006, Zurich Financial Services Group, an insurance-based financial services provider with a global network of subsidiaries and offices, appointed the former group finance director to the group managing board in the role of the chief growth officer. He will particularly have responsibility for managing a newly created growth council and assuring alignment of critical business processes with the company's growth targets. The announcement of this new position is based on the firms rigid cost-saving history over the past 5 years. While Zurich Financial Services almost exclusively focused on initiatives to increase efficiency, the insurance neglected innovation and growth strategies. Certainly, the firm managed a successful turnaround but it lost competitiveness. This becomes clear if we look at Axa – one of its main competitors. Axa has gained a good reputation of being a real leader in profitable growth, increased live assurance premium by about 20%, four times more than Zurich Financial Services. Since Axa delivered a total shareholder return over the past years that outperforms that of the Zurich Financial Service beyond means, it is time

to change and shift the behaviors, capabilities, and culture for growth. The chief growth officer may be a first answer to develop cultural conditions necessary to foster growth but also innovation and brand building as these disciplines are adherent.

Keep Focused and Develop the Brand

One consequence of merger and acquisitions is often brand confusion. The brand shows the size and power of a company and intimate client relationship. Brands reflect desires and propositions. They steer our behavior and influence our opinion whether we trust, buy a product, or use a service of a certain company or not. There are different sets of branding in private banking, those that project themselves as wealth manager units of international banks such as Citigroup Private Bank, Credit Suisse Private Banking, or Deutsche Bank Private Wealth Management and those smaller wealth managers whose brands are named after their founders such as Coutts, Julius Baer, or Pictet & Cie. Where the universal banks attract mainly prospects that are new to private banking, the others typically promote their heritage and attract old money and families that seek discretion and prestige. Branding is becoming increasingly important in private banking as they operate in the luxury business. It is particularly important in attracting and retaining profitable clients. Looking back to the 1970s, Pictet & Cie, a renowned private bank in Switzerland, had no logo, no advertisement, and the name Pictet did not even appear on their buildings. It was common practice to be discreet. The bank evolved and moved, over time, from discretion to greater visibility and is today recognized as a major brand in private banking. This transition was a cultural revolution, as Jacques de Saussure, Partner at Pictet & Cie noted. What started at Pictet in the 1990s to make the brand reflecting the firm's evolution is nowadays a generally accepted communications strategy. This means that the brand must reflect constant values such as reputation, integrity, excellent quality, discretion, and long-term survival but also the firm's agility. As banking has been changing, it is a challenge to ensure a constant adequacy between the brand and a firm's business activities. In particular, if global expansion is part of the strategy.

Most brand rankings assess the risk profile of earnings forecast. Interbrand, for example, examines brands through the lens of financial strength, importance in driving consumer selection, and the likelihood of ongoing branded revenue. The analysis also includes market leadership, stability, and global reach – or the ability of an organization to cross both geographical and cultural borders. Including all these factors generates a discount rate, which is applied to brand earnings to get a net present value. It is believed that the net present value comes closest to representing a brand's true economic value. If we look at the recent table of 2008, it is remarkable that the first ranked companies of the service sector – in spite of the financial crisis – are exclusively banks. Although far behind top-ranked companies such as Coca Cola, Microsoft, or IBM, Citi was ranked on 19 with a calculated brand value of US \$20 billion. Citi's success can be explained with the launch of their new brand campaign in 2002. Once the world's largest bank, Citi unveiled its new image

through a global campaign that highlights the unparalleled capabilities of this vast and unique business. The advertising campaign emphasizes one or more core strengths that bound together with the new tagline “This is Citigroup, tell the complete Citigroup story.” Citigroup’s quest to generate more revenues from international markets is leveraging its brand value to emerging markets. If we pick out firms in the financial service sector from the brand ranking, HSBC (27), Merrill Lynch (34), JP Morgan (33), JP Morgan (37), Goldman Sachs (37), and UBS (41).

Opinions are divided over this issue. Some argue that multibranding strategies remain typical for more product-driven industries. Companies must always view brands through the eyes of their customers. In fact, companies might think that they own their brands, but customers think that they have a stake in them and hence branding managers need the customer’s permission to make changes – at least to a certain extent. Henri de Castries, the CEO of Axa, recently emphasized the importance of their one-brand strategy. Because the brand must be respected as it is part of the firm’s culture and history and valued by customers and employees, he will not act like Napoleon. Nevertheless, he stated that it is a question of time until the name Winterthur disappears from the corporate landscape. The trend toward a one-brand strategy is reflected in the financial service industry by a number of large firms such as Axa, Credit Suisse, Merrill Lynch, or UBS just to name a few. Other multinational firms are to follow these examples. In contrast, the Royal Bank of Scotland, for instance, retains multibrand strategies, at least for some of their businesses. HSBC as well has adopted a slow approach to consolidation of brand recognizing the importance of specific brands to clients.

Main criteria for the decision to collapse brands of a group and focus on one name are factors such as innovative products, competitive prices, or technical primacy, and above all, customers want a bank of the size and expertise they can rely on. Generally, a firm’s adoption of a single brand for all its businesses illustrates the ultimate ambition to client focus for expansion and innovation. It is clear that rebranding is accompanied with enormous marketing efforts. In addition, firms have to adapt structures, processes, and services thoroughly down to application architectures and shared systems. Customers all over the world benefit from these improvements, in the way that they can access services provided by the various business units of the same firm without even noticing it. Seamless resource sharing is often reflected in integrated client service models, as one attempt to leverage a *one-firm* philosophy. Although the improvements coming from an integrated firm are difficult to quantify, significant strategic advantages can be achieved through resource sharing among different organizational units. More about the benefits and threats of integrated banks is discussed in the last chapter of this book.

Leveraging Innovation to Grow

To recapitulate, growth has always been and still is the ultimate goal of companies – at least in a capitalistic economic system. There are a number of growth opportunities. Stimulating client needs, winning new clients, improving the service level of

existing clients, or growing through cross-selling is just one building block for growth. Another building block can be seen in the area of products and services. Developing new products and services, improving existing products and services, or bundling them to new value-adding solutions might accelerate demand. In addition, there is potential for growth by developing new distribution channels and exploring new markets. Here, collaboration with suppliers as well as distributors must be part of strategic thinking. A key challenge for managers is balancing organic growth and growth by acquisition. What strategy ever we emphasize the importance of profitable growth.

Within this section, we also attempted to explain brand value. To portray brand value in simplified terms, it is the recognition how stakeholders perceive a company. It offers an extra value, i.e., one in addition to the company value or product or service. It is assumed that the success of a company's growth strategy is linked with its brand value. Understanding sustained and profitable growth just by looking at the brand value rankings or annual reports is impossible. We need to concentrate on the process that created those results and influenced shareholder to invest in a brand. As shareholders, clientele, workforce, products all are spread around the globe, we need to dive into communications strategy. Therefore, firms that aim to expand internationally need to slice its advertising campaigns along dimensions such as geography and customer segments. This sounds logical but we often recognize global marketing campaigns without considering market specifications or customer segmentation schemes. For successful global expansion, we must understand and respect the cultures of the individual markets.

On the long run, sustainable growth can only be achieved either by increasing the labor hours that is required to produce a product or service or by increasing productivity. This is particularly difficult for developed economies with almost full employment, high labor hours, and productivity at high level. Leveraging these drivers is therefore hardly possible. Pursuing innovation with the primary objective to grow is suggested as the solution. Some companies have been strengthening their innovation activities for good reason – it simply turns out. Innovative companies have superior long-term stock market performance as a study by the Boston Consulting Group shows (see Fig. 2).⁹ Accordingly, global innovators that encompass the top 25 most innovative companies overall had a median annualized shareholder return of 14.3% from 1996 to 2005, a full 300 basis points better than that of the S&P Global 1,200 median. The survey confirmed for all regions that innovative companies have the capacity to generate more total shareholder return. The reason for that outperformance was these companies' ability to expand margins at a superior rate without sacrificing growth.

Considering innovation as key driver for growth seems to be the logical conclusion. We must understand the process itself that tells us which innovations lead to new growth. That is important because growth can only be achieved if aligned with innovation strategy. The aim of the next section is to first explain innovation and then align growth strategies and innovation strategies.

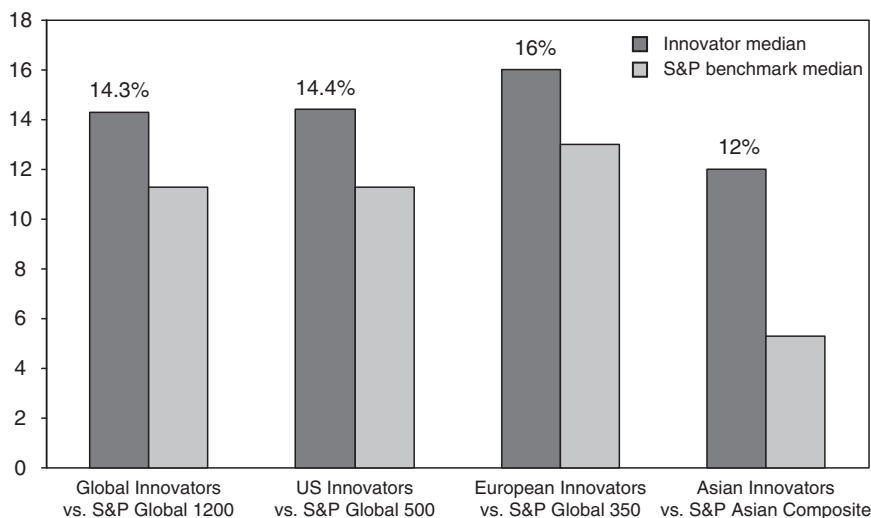


Fig. 2 Ten-year annualized total shareholder return for innovative companies vs. relevant benchmark from 1996 to 2005

The Power of Innovation

What Is Innovation?

The term *innovation* is understood diversely and therefore a variety of interpretations is found in the literature. Without going into deep discussion about the Latin verb *innovare*, which means “to make something new,” it can be said that innovation is a term broadly used for any kind of novelty. In terms of business, it commonly refers to the act of introducing a new product or service into the market or improving existing things. Whatsoever, innovation is used not only for products and services but also for concepts, strategies, and paradigms. Innovation comes in many different forms, from the truly revolutionary to the almost mundane. It involves the creation of new designs and ways of doing things, their commercial exploitation, and subsequent diffusion through the rest of the economy and society. Innovation is one of the main engines of long-run economic growth and structural change and has always driven economic progress. Innovation is the cornerstone of the Lisbon strategy, which was drawn up by the European Council in March 2000 to render the European Union, the most competitive and dynamic, knowledge-based economy in the world by 2010.¹⁰ Accordingly, we understand innovation as:

- The renewal and enlargement of the range of products and services and the associated markets
- The establishment of new methods of production, supply, and distribution
- The introduction of changes in management, work organization, and the working conditions and skills of the workforce

We state that innovativeness is the property of being an innovation. But the understanding of innovation depends on the perspective from which it is viewed. From a general economic point of view, the innovation must increase value for the firm, the consumer, or the producer. For consumers, innovation means higher quality and better value goods, more efficient services, and a higher standard of living. Enterprises, on the other hand, expect more efficient production processes, improved business models, or new products and services, which lead toward sustained, improved growth, and higher profits for owners and investors. Employees may see benefits such as new and more interesting work, improved skills, and higher wages coming out of innovations. From an organizational perspective, firms without innovation would not survive because new products and services, and new or improved ways of doing business are vitally important for business continuity and growth. Hence, failure to innovate equals failure to differentiate equals failure to gain the profits needed to attract investors. In sum, innovation is about creating value and increasing productivity in any industry or economy. Innovation can deliver increased revenues, enhanced value added, and stronger sustainable competitive advantage. Since the creativity and inventiveness of companies are a country's greatest assets, for the economy as a whole, innovation is the key to higher productivity and greater prosperity for all.

It is essential to understand that innovation has its origin in almost all imaginable areas. These include not only management and leadership styles, processes, product and service development, but also the meanings and beliefs, which employees assign to organizational conduct and corporate culture. Later show how innovation influences individual's motivation and the way they behave. It is essential to understand how innovation helps to develop a better understanding for reaching and servicing customers, production techniques and methods, product quality, approaches to information and knowledge management, forms of partnerships, or management and stakeholder participation.

As the economic benefits of the successful exploitation of novelty are captured by enterprises rather than by universities and research laboratories, companies are constantly forced to innovate by pressure and trends, notably competition and growth. In respect of the different strands of thoughts on innovation, we believe that novelty is vital to companies and occurs from the four main routes, namely invention, value innovation, imitation and adaptation, and open business models.

Invention

The industrial economic model of investing into innovation is through research and development (R&D). The exploitation of invention arising out of the research laboratory is an important and much studied route to innovation. Research is a major contributor to innovation, generating a flow of technical ideas and continually renewing the pool of technical skills. Invention as a source of innovation is commonly associated with *technology push*. This means identifying an interesting technology, making a product out of it, and finally, searching for a marketplace.

To specify, inventions produce the technological push for the development of new products, processes, and services. In theory, the rate of research and development expenses should correlate with the rate of revenues. To prove the sustainability of the current business model, the two curves should grow similar. Research and development is therefore a fundamental component of innovation-led growth. This is vital because new products and services or improved processes drive competitive advantage in companies. While the R&D model has a long tradition in manufacturing, it cannot easily be adapted to services due to the absence of a physical product. We will discuss these differences later on in this book.

In general, we can say that innovation is not dependent on invention in any direct manner. Companies have not necessarily to invent to innovate. Regarding history, a prominent saying is that innovations come and go while inventions stay. Nevertheless, innovation has played a more important role in economics and business than the concept of invention as Josef A. Schumpeter claimed in the 1930s.¹¹ Accordingly, the social process, which produces innovations, differs economically as well as socially from the social process that accounts for inventions. Schumpeter identified innovation as the essential function of the entrepreneur, along with credit and profit maximization and repeatedly emphasized that innovation is possible without anything we should identify as invention, and invention does not necessarily induce innovation but produces of itself no economically relevant effect at all.

Although innovation is often confused with invention, the latter is nothing more than the first step in a process of bringing new ideas to widespread and effective use. Innovation is about adding value to inventions. Think of the invention of the credit card in the late 1960s. Besides the creation of a global partner network, a number of innovative services such as insurances and loyalty schemes finally increased value and made the credit card to an accepted payment method.

Value Innovation

Value innovation places an equal emphasis on value and innovation for consumers, customers, and the company. The aim of this concept is to create growth strategies, new products, and services or just reconfigure existing products and services to present a radical change that will be perceived by customers as offering more or better value. The logic behind this is simply to do things completely differently or to change things radically. Value innovation explains new and fundamentally different ways of competing in an existing business, i.e., one that conflicts with the traditional way. In view of this, a strategic innovation occurs when a company identifies gaps in the industry and attempts to fill them. These gaps can be newly emerging customer segments and needs that are not served well by competitors, or new ways of producing, delivering, or distributing existing as well as new products and services to existing, or new customer segments. Thus, it breaks with past practice in at least three areas: value chain, design, and conceptualization of customer value and identification of potential customers. In particular, understanding cus-

tomer value with sufficient precision is vital for companies that aspire to growth leadership. On the bottom line, it is the difference between benefits as perceived by customers and the price paid for a product or service.

Value innovation is not about striving to outperform the competition, nor is value innovation about segmenting the market and accommodating customers' individual needs and differences. Value innovators ignore current industry conditions, the competitive environment, and conventional strategic logic and look for blockbuster ideas and quantum leaps in buyer value to create new markets. They suggest placing the buyer (client), rather than the competition, in the center of strategic thinking. If smaller firms in the banking industry for instance act as value innovator, they accept that they cannot beat firms such as Citigroup, Bank of America, HSBC, or the like by playing their game. But it may be possible to prosper and survive by playing an entirely different game. Therefore, the only realistic hope of survival in a very competitive retail banking market that is taken by very large banks can be a strategy that is truly customer centered and focused on local needs.

The concept of value innovation is in stark contrast to competition-driven strategies as championed by Michael E. Porter in the 1980s.¹² Defending competitive space within the Porter model has been constantly eroded in today's dynamic and global economy, as entry and mobility barriers are relentlessly assailed. The proclaimed advantage of creating new marketspace as a result of redefined customer's hidden demand or to create totally new demand is in contrast to *market-pull* strategies. For the latter, a marketplace is first identified and then a product or service developed which meets that need. In the case of value innovation, companies are driven by the market. They accept the market structure as given and do not aim to change markets. Concentration lies on analyzing and understanding customer needs. Once this is known, products and services will be produced that satisfy the expressed desires of the customer. This consumer perspective points to the power of the market, where the market is the hub for the demand that inspires innovation. For example, in commercial banking, innovations in ATM and Internet-based offerings helped to create new value by breaking traditional compromises with respect of availability, reaching, and servicing customers. This corroborates the thesis that technological innovation and value innovation combined contribute to value creation.

Imitation and Adaptation

Referring to Schumpeter, imitation is the third force of innovation after invention and innovation that involves commercialization of the invention. Although he warned that "swarms of imitators" can erode profits for pioneers and that imitation is a nonstrategic approach that leads to the diffusion of innovation, it is accepted today as a strategic route to innovation. Imitation is known as the approach where an initial innovation is taken from the same industry, developed, and improved further to the firm's advantage. Adaptation is close to imitation and is often used within the same breath. Adaptation is the approach where a company takes an idea from other business sectors or industries and adapts it for use in its own production

processes or market. Adaptability is in essence the ability to reconfigure internal activities and processes to cope with the demands from its environment. One form of adaptation is adapting customer behavior. Some might have heard from the “adaptation–innovation theory,”¹³ in which individuals tend to be either adaptors or innovators. This though can, of course, be adopted for organizations. Research found that banks in the 1980s and earlier generally developed their services by reacting to customer needs and adapting those needs to fit the bank’s existing framework.¹⁴ The adaptation approach is often pursued unconsciously whenever benchmarking is performed. As organizations strive for better performance, benchmarking has become increasingly important. In practice, this means observing, adapting, and copying best practice from others within the same industry as well as other industries and even other sectors. Thus, generated knowledge about current practice is often seen as precursor to changing and improving that practice. The fact that companies must benchmark to improve their activities and their competitive-ness explains the increasing emphasis on organizational effectiveness.

The rationale behind imitation and adaptation is the fact that new product and service development ab initio is costly, risky, and time and resource consuming. Copying the latest technology, products, services, processes, or state-of-the-art practice and management strategy may be a useful approach for overcoming the uncertainty for doing things that have never been done before. Especially if other companies have been successful with it, there is no point in reinventing the wheel. Every success leaves clues and organizations are sometimes better off by just looking at what others have done, what worked, and why it worked and then copying the concept, and adapting it to make it their own. Former leading industrial enterprises, therefore, often find strong competition from innovative newcomers such as Intel, Microsoft, Sun, Oracle, Cisco, Genentech, or Amgen that conduct little research on their own. Imitation of R&D-intensive goods in the manufacturing sector is faster and less costly than in-house R&D. Even with patent protection, imitation occurs regularly and not long after innovation. The Japanese industry in the 1970s and 1980s evidenced that imitation can be a strategy that outperforms *real* inventors or innovators. In banking, we see that time for imitating and copying a competitor’s product is shortening. This practice has been growing in recent years with structured investment products, which are designed to meet specific investor’s needs that cannot be met from the standardized financial instruments available in the markets. Such packaged investments using derivatives to replicate market performance, sometimes linked to a money-back guarantee, are in Europe sold by national post offices, and in the United Kingdom even by supermarkets to their customer.

Although there is a plethora of simple structured investment products available, there is room on both the life insurance and the banking side. Nevertheless, launching products for distribution at the mass retail level calls for firms that do things differently, rather than just do things better. Imitation and adaptation alone are therefore not enough. Thus, all firms have the ability to break out of what may have become an inhibiting traditional *modus operandi* – and such ability could, in competitive and high-velocity markets, be more advantageous than in others. A later

argument highlights the importance that firms should consider new business opportunities simultaneously.

Open Business Models

Business model and strategy are confusing terms that are often used interchangeably. For both, there is no universally accepted definition of the term. The business model is distinct from strategy; however, understanding each of its components and how they interrelate can help managers to make better strategic decisions. Main difference is that a business model starts by seeking and creating value for the *customer* while strategy is mainly concerned with *competition*. A business model is an abstraction of a business, which identifies who the customers are, what the customer value is, and how the business makes money. Principally, it describes the mechanisms by which a business intends to generate revenue and profits. Thus, it provides a cognitive framework – a mental model on how inputs are transformed in value-adding outputs or economic value. Correspondingly, outputs are products and services that are performed by the processes and operations of the business. Ultimately, a business model is concerned with how to create *value for the business*, in contrast to strategy that seeks *value for the shareholder*. While the business model forms the underlying rationale for being in business, the strategy is the plan of how to put that business model into action. The business model must create value in its ecosystem and must capture a portion of that value for the innovator, so that additional advancements will be forthcoming.

The pace of change has become so rapid that companies have to monitor the changing business environment continuously, and evolve and adapt their business model to reflect the changes. The crux is to balance these streams, otherwise it may cause a dysfunctional mismatch between today's business environment and the business models. Therefore, we suggest a more dynamic, open, and flexible approach to business models. Business models are used in strategic planning and have an impact on every organization, regardless of whether it is a new venture or an established large multinational company. One might argue that when a new business model changes the economics of an industry and is difficult to adapt or imitate by others, it could by itself create a strong competitive advantage. Many executives see their business model as a more important source of competitive advantage than their products as these particularly in the banking industry are becoming increasingly commoditized.

The effects of business model innovation are hard to predict. Moreover, they emerge over time and can transform the full breadth of the economy. For example, in recent times the shift from *marketplaces* consisting of sellers, buyers, and physical places where the two come together, to *marketspaces* where transactions take place free from the bonds of time and space has fundamentally altered the way companies interact with their customers. As the radical shift from physical places to virtual (information) spaces requires a shift in thinking on how to add value, companies have to adjust their strategies and business models accordingly and find out when virtual is virtuous. New business models are often driven by customer needs,

technological innovations, or other changes in the business environment and affect a number of different types of innovations. In an open business environment where firms look outside their boundaries for ideas and knowledge, they can bring in, as well as license or provide their intellectual property to other firms. Henry Chesbrough talks in his latest book “Open Business Models” within this context of “division of innovation labor.”¹⁵ He states that an open business model utilizes this division of innovation labor for the creation of value but also to capture a portion of that value. Overall, *open* business models create value for customers as well as for the company by leveraging many more ideas, due to their inclusion of a variety of external concepts. It is therefore important to create new ideas with outside stakeholders by embracing open innovation and knowledge sharing.

Different Types of Innovation

Having discussed the routes to innovation, there are after all different types and concepts of innovation. The understanding of various types of innovation is important, as there is a correlation between the type of innovation and organizational performance. Schumpeter, again, was one of the first to mention five types of innovation, namely product innovation, production process innovation, innovation in organization, new market behavior, and new raw material.¹⁶ The current understanding is that product innovation is destined to resolve, circumvent, or eliminate a technical difficulty in manufacture or to improve services. Process innovation can be assigned to innovations for the purposes of saving inputs such as energy conservation or automation. Innovation in organization as the third major category aims to improve the conditions of work, in particular innovations in methods and management.

While product innovation is about what a company offers, process innovation is about the way of effectively and efficiently producing and bringing these offerings to markets. The general aim of process innovation is to reduce costs, improve efficiency, raise productivity, and increase profitability. These process innovations may affect and change industry and society radically as evidenced in history. First endeavors to improve processes in manufacturing had been made by Frederick Winslow Taylor who measured and reformed work processes around 1878 at the Midvale Steel Company in Philadelphia. His contribution to more efficient production processes became later known as *Taylorism* and changed management strategies and production significantly. Henry Ford's success with the Ford T-Model 35 years later was based on Taylor's concepts. Ford just designed and implemented processes and techniques that could be repeated identically and indefinitely. The *assembly line* as the next great process innovation was born. A recent application of Taylor's concept of separating the design of work from its execution is the *business process re-engineering* approach.¹⁷ Focus here is on an organizational rather than an individual level, whereby any organization regardless of size, type, and objective operates fundamentally by transforming a collection of raw material for manufacturing industries and raw data for service industries into required outputs such as products or services. The pure focus was on fundamental rethinking and radical design of business processes

with the objective of improving the quality, service, cost, and speed of core processes regardless of cultural or social values. The application of business process re-engineering transformed whole industries and has been considered retrospectively as a too mechanistic and radical approach by a large number of opponents. The main critique of this approach was that it ignored the importance of people, describing them as objects who handle processes. Retrospectively, we know that such view can have devastating social and macroeconomic consequences.

The two main types of innovation – process and product innovations, respectively, underlie different concepts. While innovation in the area of processes and business models is often seen from a strategic point of view and assigned to the concept of strategic innovation, new product development is often marketing related. However, later should not be mixed up with *marketing innovation*.¹⁸ While the term is related to the improvement of customer-touching processes or consumer transactions to stimulate demand, others see it just as innovative design and presentation technique for new forms of positioning advertising, and differentiation. Marketing innovation is usually claimed to be the part of innovation strategy that reflects the recognition of new ways of organizing work in all areas of a company.

There is dispersion and variation in the interpretation of routes to innovation and types of innovation. In the next section, we would like to discuss innovation in an industry-related context.

Innovation in Different Industries

Considering what the most innovative companies are, we often think of Apple, Google, 3M, Toyota, Microsoft, General Electric, Nokia, Sony, IBM, or Starbucks Coffee. Surely, these brands have dominated many rankings and press releases or have been used as case studies for numerous MBA studies and advanced management program. *But what does it take to be consistently recognized as top innovator and why are there no service firms or even banks?* Innovation capability and its management are clearly sector or industry specific, if not firm specific. Most attempts to explain innovation are based on research in the manufacturing sector. Further, innovation of intangible products and services is hard to measure. Tracking and assessing inputs, outputs, and innovation processes regardless whether we talk of incremental or radical (breakthrough) innovation require a set of metrics to measure them. Measurement of innovation in the service sector has low priority and what is more, few companies tie incentives to innovation metrics.

Our intention though is to emphasize the importance of the service sector and to discuss how different industries within this sector approach innovation. Therefore, we divided broadly two sectors, namely manufacturing and service. Table 1 compares the characteristics of sectors and shows differences that remain significant when conceptualizing services. Having understood the traits of the service sector, we turn to next and discuss innovation in the financial service industry. We then dive deeper and explain the characteristics of services in banking, and finally attempt to find answers how to measure success in service innovation.

Table 1 Innovation system traits of manufacturing and service

System trait	Manufacturing	Services
Product characteristics	<ul style="list-style-type: none"> • Tangible • Easy to store • High transport and distribution costs 	<ul style="list-style-type: none"> • Intangible • Easy to multiply and transport
R&D organization	<ul style="list-style-type: none"> • Project-oriented • Budget-driven • Research and development units aligned 	<ul style="list-style-type: none"> • Chaotic • Costs often not assignable • Research often outsourced
R&D approach	<ul style="list-style-type: none"> • Systematic • Scientific 	<ul style="list-style-type: none"> • Ad hoc
Intellectual property rights	<ul style="list-style-type: none"> • Strong, patents 	<ul style="list-style-type: none"> • Weak, copyright
Technology orientation	<ul style="list-style-type: none"> • Technology-push • Science- and technology-led 	<ul style="list-style-type: none"> • Technology/market-pull • Consumer/client-led
Innovation approach	<ul style="list-style-type: none"> • Mainly in-house resources (except high-technology industry in certain clusters) 	<ul style="list-style-type: none"> • External and internal sources combined
Innovation cycle	<ul style="list-style-type: none"> • Short 	<ul style="list-style-type: none"> • Long
Innovation form	<ul style="list-style-type: none"> • Attempt to be radical 	<ul style="list-style-type: none"> • Mainly incremental
Commercialization strategy	<ul style="list-style-type: none"> • Prototyping and testing 	<ul style="list-style-type: none"> • Direct to markets
Knowledge condition	<ul style="list-style-type: none"> • Make use of existing scientific knowledge 	<ul style="list-style-type: none"> • Create new service-specific knowledge
Time to market	<ul style="list-style-type: none"> • Short to very long (depends on industry and product) 	<ul style="list-style-type: none"> • Relatively short (little need for research or acquiring scientific knowledge)
Innovativeness characteristics	<ul style="list-style-type: none"> • Big 	<ul style="list-style-type: none"> • Small
Spatial scale of system or reach	<ul style="list-style-type: none"> • Technological • From national to global 	<ul style="list-style-type: none"> • Social • From regional to national to global • Many services are national because of law an regulatory constraints
Labor productivity	<ul style="list-style-type: none"> • Depends on industry (from very high in high-technology, computer, and software to low in heavy metal industries) 	<ul style="list-style-type: none"> • In most industries very high (highest in financial services)
Physical capital	<ul style="list-style-type: none"> • High • Ownership of production 	<ul style="list-style-type: none"> • Low • Outsourcing/leasing

Innovation in the Financial Services

Key Innovations That Changed Businesses

Assuming that a product is anything that can be offered to a market for attention, purchase, utilization, or consumption that satisfies a desire or need, it can include

physical goods as well as intangible services. The specificities of innovation in services are in the innovation types. Under financial innovation, we understand the design, development, and distribution of any new financial product or service. But financial innovation can also mean the change that advances altering or modifying the role of financial institutions in general. Financial innovations aim to response to globalization and risk or to regulation and tax issues among various other areas. In any case, it is an ongoing evolutionary process. To reduce complexity, we categorized innovation for the financial service industry into three generic forms. This includes product and service innovations, process innovations, and innovations common to organizational function and service delivery. Later innovations include open business models and affect organization and management. The definition of innovation in services is difficult because product, service, and process innovation are sometimes overlapping. In addition, there is no strictly linear, sequential process, but rather there exist interaction and feedback at several stages of the innovation process. To gain a better understanding what innovations in the financial services could be, we listed key innovations in banking between 1960 and 2007 from various sources. Some landmark innovations such as credit cards, automated teller machines (ATM), Internet banking, or open architecture changed not only customer behavior but also banking businesses fundamentally (see Table 2).

By going through the listed key innovations, you may rightly ask whether that is all what banks delivered. Firms in the service sector and particular banks are not innovative at all compared to the manufacturing industries. That is correct but we must differentiate the various businesses of the financial services to gain a better understanding of innovation. To simplify, we focus on banking and distinguish between five main businesses, namely retail banking, commercial banking, private banking, investment banking, and asset management. These businesses all have different market segments, structures, cultures, strategies, business models, and offerings. Retail banks are institutes that undergo transactions directly with consumers, rather than firms or other banks. They offer savings, accounts, credit cards, mortgages, personal loans, and so forth. Commercial banking or corporate banking refers to deal with deposits and loans from corporations. Private banking, on the other hand, refers to the customer service being rendered on a more personal basis than in mass-market retail banking. Private banks, labeled interchangeably as wealth managers, usually provide comprehensive advice and a broad range of investment products and services tailored to the complex needs of wealthy individuals. Solutions include wealth investments, inheritance advice, tax planning, pension planning, trusts, and foundations. Investment banks are dedicated to serve companies and governments. They typically provide financial advisory, debt and equity underwriting, capital raising services, as well as issuing and selling securities. Much of their business is about giving advice on transactions such as mergers and acquisitions. One prominent financial innovation of investment banking is the mortgage-backed securitization that started in the middle of the 1970s, when its architects found that a system is missing that has the capacity to free up enough money so that almost anyone who wanted a mortgage could get one – even people with no securities. After a number of deregulations, the mortgage-backed securities

Table 2 A selection of key innovations in banking

Category	Innovation	Adoption date (est.)
Service delivery or access to financial markets, i.e., new products and services	Bond	1960s
	Eurobond	1963
	Credit cards	1969
	Junk bond	1970s
	Convertible bonds	1970s
	Money market deposits	1970s
	Money market mutual funds	1970s
	NOW account	1970s
	Collateralized mortgage	1970s
	Derivates	1970s
	Cash management account	1978
	Certificate of deposit	1979
	Mortgage-backed securities	1980s
	Adjustable rate mortgage	1980s
	Variable rate mortgage	1980s
	Self-directed IRA account	1980s
	Sweep (asset management account)	1980s
	Debit cards	1987
	All in one account	1990s
	Direct payroll deposit	1990s
	Structured products	1990s
	Credit derivatives	1993
	Exchange-traded fund (ETF)	1993
	Trackers savings account	2000s
	Weather derivatives	2000s
Organizational functions, i.e., processes	Risk management systems	1970s
	Automated voice response systems	1980s
	Automated check	1980s
	Computerized loan document generation	1980s
	Discount brokerage service	1980s
	High-speed image processing of check	1980s
	High-speed image processing of office documents	1980s
	Truncation of check handling process	1980s
	Telephone banking	1983
	Automated mortgage origination	1990s
	Centralized loan application process	1990s
	Customer information file	1990s
	Electronic trading of shares	1990s
	Loan tracking system	1990s
	Profitability analysis by customer	1990s
	Straight through process	2000s
	Customer needs-based segmentation	2000s
Common to both organizational function and service delivery	ATMs	1967
	Home banking	1983

(continued)

Table 2 (continued)

Category	Innovation	Adoption date (est.)
Miscellaneous types of innovation	Electronic fund transfer (PoS)	1985
	Branch automation	end-1990s
	Transaction portal	end-1990s
	Internet banking	1997
	Mobile banking (GSM and WAP services)	1999
	Lockbox system	1980s
	Treasury workstation	1990s
	Lobby automation (video banking)	1990s
	Loyalty schemes	1990s
	One-stop banking	1990s
	Online financial management system	1990s
	Personal banker	1990s
	Open architecture	2000s

market that radically altered the United State investment landscape rose exceedingly from the end of the 1990s until 2006. Today, there is a huge debate whether the financial innovation of securitization mortgages was right or whether it damaged more in the last 2 years as it contributed over the last 20 years. Asset management is obligated to the professional management of investments across asset classes, including equities, bonds, fixed income, commodities and alternative assets such as real estate, hedge funds, or private equity. If we closely analyze asset management, we must acknowledge that these institutes have recently developed a large number of structured investment products for institutional and retail investors. These complex financial constructs compete with traditional funds of funds and simple capital guaranteed funds that have driven most of the growth until now. However, listing all the structured products innovations would go beyond the scope of this section. The evidenced innovativeness in investment product development is in contrast to, e.g., retail banking. Retail banking has become commodity business because there is moderate growth and institutional barriers inside these traditional firms to real innovation are immense. Retail banks and to a certain extent commercial banks too mainly do things that are minor or routine, and produce few breakthrough innovations. Because of cost pressure, they may be more challenged to improve their processes and application architectures. Strategic programs to renew entire platforms are huge efforts and coupled with much more than just technology. Even though, it is commonly not considered as overly innovative. For investment banking, innovations here are not of radical nature either. Over the years, an accumulation of hundreds of small innovations has changed businesses and processes in investment banking. If we look at wealth management, innovations are rather in the area of client segmentation or advisory. Since wealth management has become an increasingly lucrative business with significant growth potential, we can observe

innovation in business models of many banks. Innovations in the area of wealth management are discussed in-depth later on in this book.

The Characteristics of Services

There is confusion between products and services; especially for the term *services*, itself, there is no common shared sense in academia or practice. The International Organization for Standardization (ISO) defines *service* simply as a subset of product.¹⁹ A process, whereby the customer output is generated in this dedicated process, generates a service. The definitions in theory and practice vary and are often used interchangeably. A more comprehensive and accepted definition of what a service is might be useful at this point. It is provided by the United Nations.²⁰

Services are not separate entities over which ownership rights can be established. They cannot be traded separately from their production. Services are heterogeneous outputs produced to order and typically consist of changes in the condition of the consuming units realized by the activities of the producers at the demand of the customers. By the time their production is completed they must have been provided to the consumers.

To gain a better understanding, the distinctive characteristics of services such as their intangibility, inseparability, perishability, heterogeneity, and ownership have to be elaborated further.²¹ Inputs and outputs of services can hardly be separated in contrast to products in the manufacturing sector. Explained as *inseparability*, services are produced and consumed simultaneously and cannot be separated from their providers, regardless of whether the providers are human beings, institutions, or machines. While products are, for most industries, physical goods, services can be any activity or value that one party can offer to another that is essentially *intangible* and cannot be stored, referred to as the *perishability* of services. It varies according to the provider of the service and does not result in the *ownership* of anything. Service institutions consider products as intangible offerings to their customers and services as a service process for their customers. This is because of the fact that everything they produce is intangible, regardless of whether it is characterized as a product or service.

One remarkable feature of intangible products and services has to be mentioned. While physical products are prototyped and tested before being taken to the market, this is barely possible for intangible products and services. This is one of the weakest facets and dilutes the quality of the execution of launch. The standardization of services has been another crucial issue for years. For services, it is more difficult to ensure the same level of quality as with goods, which leads finally to a greater heterogeneity in terms of conformity and quality. Another characteristic of services is that newly developed services can easily be imitated and replicated. While intellectual property rights and patents are an indicator for invention rather than innovation, the successful exploitation of knowledge and other intangible assets is increasingly recognized as indispensable for innovation in industries such as IT hardware, automotive, pharmaceuticals and biotechnology, electronic and electrical industries. These industries are, at the same time, the top investors in R&D. This is

in contrast to the service sector as it has different propensities to inventions and patents. As new services have no technical component and rarely involve the explicit expression of a new idea – which would be a requirement for copyright – patent protection does not apply. Intellectual property rights, therefore, only offer loose protection from illegitimate copying.

Products and Services in Banking

In contrast to industrial companies in the manufacturing sector, financial service institutions do not provide physical goods but intangible products and services. For banks, these consist of liquidity, information, and transformation services. It can be said that the credit risk of a bank corresponds to the investment risk of any other company, and liquidity risk corresponds to the capital structure risk. Banks are also facing interest rate risk due to maturity transformation, and a bank risks having to refinance its long-term loans at rates that exceed the rate of interest on the loan if the interest rate structure changes. Because every single business needs a bank for their financial transactions, insolvency of a bank can have significant external impact on the overall economy. This effect is potentially more serious than if an industrial company were to go bankrupt. What in bank jargon is called *systemic risk* means that if there is a run on a bank, a chain reaction might be the consequence and could result in the collapse of other banks. A similar situation prevailed when many banks securitized credits through complex financial products. This product innovation together with the worldwide network of global financial systems and sophisticated communication technologies leads to a behavior similar to that of a shoal. Hence, all participants are caught in the same network and act and react identical. In normal times, interest rates rise and fall where the one or the other institute profits from it. This *system* is in equilibrium as long as there is trust between the market participants. Through the process of the credit crisis in 2007 and 2008, trust has gone and hoarding of money was common. Because credits were not simple credits, instead complex securities, the system collapsed. These threats justify the call for more attention on regulatory supervision in the banking industry.

The terms *service* and *product* are often used interchangeably in the financial service industry, which may lead to confusion. To clarify, several banks commonly mean products as well as services if they talk about product innovation. Notwithstanding, a distinction must be made for technical reasons. This means that a clear distinction is a requirement for the cost and revenue allocation to management information systems (MIS). We observed that most banks have recently installed global product catalogues accessible over the Internet. Through the process of studying such catalogues, the definition of products and services becomes clearer. We observed that some banks use the term *module* but found that this is rather a technical issue than something that a relationship manager would mention in front of customers. Conclusively, we categorize products, modules, and services as follows:

- *Product*. Something that a client can purchase *stand-alone*, e.g., private account, savings account, all kinds of credit cards such as classic, gold, and platinum. For instance, a credit card can be purchased without having a bank account. A product is the smallest element still of use to the customer which the bank can reasonably calculate in its MIS.
- *Module*. Something that a client cannot purchase *stand-alone*. A debit card, for example, is dependent on an account (product) and cannot therefore be sold without having an account at the bank. *Module* is a very technical term and used rarely in common communication.
- *Service*. Part of a product that is too complex that it could be automated. It therefore requires in any case an interaction with the customer. Services for direct clients include financial planning or portfolio management. Services that same universal banks provide to other financial service institutes include cash currency services such as clearing and mass payment or security services such as custody and clearing and settlement and many others in the area of asset management, private banking, corporate finance, and trade and export finance. Regardless what customer type, a service is a process that generates benefit for the customer.

The strategic choice of the appropriate products and services is key in banking. In addition to accounts, cards, and lending, structured investment products typically account for a large part of revenues. Investment product ranges from equity and bonds to alternative asset classes. Today, many banks have invested their clients' portfolios in alternative asset classes with hedge funds, private equity, real estate, derivatives, and special capital guaranteed products. In particular, mutual funds have increased in popularity as they pool money from thousands of small investors. The fund manager then invests this money into equities, bonds, or other securities. By contributing money into a fund, investors attain a diversified portfolio that minimizes their risk. Besides the conceptualization of innovation in different sectors, the knowledge and information intensity of services have specific features, i.e., they underlie innovation cycles that differ from manufacturing. The next section attempts to give you an idea about the differences in the development process of services.

The Product and Service Development Process

To answer the question, we would like to focus on new product and service development and elucidate on how financial service firms manage their product innovation processes. Note that both product and service development use similar underlying processes. Accordingly, the development of new services encompasses the following phases: idea generation, concept (development and evaluation), development, and implementation (product and service launch). The phases are conducted sequentially and partly in parallel. The process is completed with a number of marketing, sales

strategy, and execution activities. Despite this structured process, there are studies that found that banks did not make systematic efforts to collect new ideas,²² while others corroborated the chaotic approach to innovation.²³ We have all experienced that ideas for new services emerge almost everywhere in the organization. Through the entire development process of new services, banks as well as insurance companies rarely involve customers, front office personnel, and intermediaries. This may be because of barriers such as functionally departmentalized structures, limited use of new service development tools, conservative organizational structures, and constraining information technology. However, we believe that firms with a more formalized development process have better chances of success.

In contrast to the ad hoc innovation process in the service sector, there are well-tested scientific methods for developing and refining manufacturing goods. Although services imply special characteristics, innovation concepts from manufacturing can be applied to services only to a certain extent. A good example is the concept of in vitro product and service testing, and in vivo experimentation of new business models.²⁴ As simple as it is, an experiment is just as good as the learning it produces. Certainly, the rate at which a firm can learn by experience depends on factors such as iteration time, the extent to which the experiment is run in parallel or series, or the total costs of designing, running, and analyzing the experiment. However, these factors and many more are all unique to the organization. Experimentation in manufacturing has been at the heart of all innovation for years, but we should consider the adoption of these concepts in services. Thus, service firms must develop and systematically evaluate prototypes of new ways of delivering their services to their customers. To do so, systematic learning is required to strengthen the consistency and productivity of service innovations. Learning through experiments can lower the risk of launching new intangible products and services. This approach to innovation is less hazardous and can significantly improve the innovation process for new services.

The Bank of America, for instance, has proved that service development can be as thorough and structured as product development.²⁵ Given the fact that they had no rigorous research and development processes, the bank created at the beginning of 2000 a new corporate unit called innovation and development (I&D) with the mandate to test new ideas. Their five-stage process to conceive and execute service innovation experiments is grouped into:

1. Generate and evaluate innovative ideas from internal and external sources.
2. Plan and design possible trials.
3. Rollout certain ideas within the prototypes.
4. Create a stable operating environment for testing new concepts and ideas and measure customer response over a given period.
5. Evaluate ideas and recommend launches in wider test markets.

Based on this process, Bank of America created an “innovation market” by setting up 25 out of over 200 branches in the United States within the existing network into prototype branches. As it would be difficult to conduct a diverse array of experiments within the existing designed bank branches, they reconfigured the prototype

branches into various categories, each with dedicated physical setup, processes, and knowledge of employees. To give you an example, they created “financial centers”; calm and spacious branches where customers had access to latest technologies required for equity trading and portfolio management. Experienced service staff supported these services. The “express centers,” on the other hand, were designed for customers that wanted to perform quickly routine transactions such as deposits and withdrawals. They also designed a number of branches as “traditional centers”; familial-looking branches that provided conventional banking services supported by new technologies and advanced service processes. Within these laboratories, they were running a series of service experiments with the attempt to find new service concepts for retail banking. The experiments conducted by a corporate research team with actual customers during regular business hours generated an unprecedented surge of creative thinking about how to increase branch excellence. The program has resulted in about 20 innovations recommended for national rollout and what is more, within the innovation market, customer satisfaction has improved significantly and even attracted new customers.

What Determine Success in Service Innovation?

Performance as a measurement factor for success in service innovation can be assessed at three levels, namely product level (profitability, market share, and revenue), project level (time, cost, and function), and company level in terms of excess returns generated through sustained innovation capabilities.²⁶ Other approaches to measure innovation group factors into inputs (financial resources being committed, people, the number of ideas generated and the expected payback for each, and key capabilities); processes (resources expended per individual project and on average, cycle time for the entire process and specific parts, the number of ideas that are moving from one stage of the process to the next, the difference between the initial expected value of an idea and the actual realized value); and outputs (the number of new products or services launched, incremental gains in revenues and profits, cannibalization of existing product sales by new products, and the return of investment of the firm’s innovation capability).²⁷

Certainly, there are other indirect metrics such as knowledge gained or impact on the brand. However, if we compare successes with failures of new product development between the manufacturing sector and the service sector, there are similarities between both sectors. Often, they influence the factors, which distinguish services from physical goods, how organizations achieve new service success. The quality of the delivered service, on the other hand, might have important implications for performance-related outcomes such as customer satisfaction and customer retention. This is because the customer is part of the service delivery process and therefore, customer participation is crucial. The extent of the customer’s involvement is vital for the added value and quality of the service that can be provided in, for instance, a banking relationship. The closer and better the relationship between

the customer and the bank, the higher the satisfaction and retention of the customer. A comprehensive understanding of the client's service expectation, as well as variations in those expectations across different customer segments, is fundamental to deliver a superior customer value proposition. This, however, is what affects the overall quality of the service. Examining the extent to which the delivered service meets the client's expectation is finally the only meaningful way to measure service quality. It is the holy grail. The problem of measuring service success is a matter of understanding accurately what the client wants and what is important to him/her. Many service firms are often too concerned with process improvements based on assumptions what is important to the customers.

One common factor of success in service innovations, regardless of the industry, is the time it takes to bring a product or service to market. Speed in the innovation process, alongside with factors such as cost and efficiency, is crucial. Let us believe that time to market is a factor that is judged by most customers as important. At least, it is the perception of many of us.

Is Time to Market a Myth?

On average, it takes between 6 and 12 months in the United States and United Kingdom for banks and insurance firms from a product being conceived until its being available for sale. While many companies hold the position that speed has a positive impact on revenues, some argue that benefits of rapid product development in financial services are largely intangible or that there is no significant link between time to market and revenue at all. On the other hand, early market entries with new products have become crucial and offer significant first-mover advantages such as charge premium prices for a lead period, gain information ahead of other firms about future customer needs, and reputation for being able to offer state-of-the-art products. Additional reasons for faster new product development can be found in the area of customer relation and loyalty, changing customer needs, maintaining revenue streams, and competitive pressure – all these factors force firms to improve their product development time.

We assume that all product and service development efforts may benefit from process innovations. Although process innovations might result in better performance and cost reductions, one might also state that the main driver behind such re-engineering efforts at financial service institutions is not cost reduction per se, but improving customer service quality. *But what are the barriers to rapid product development?* We see the main problems in unfocused strategy, insufficient senior management support, poor economic conditions, organizational inflexibility, and high employee turnover. Difficulties and innovation failures are often due to organizational rigidities and a lack of qualified staff. In addition, regulations may hamper innovation likewise. Product managers claim that the time from the idea to selling the product is mostly consumed during controversies between other business units such as marketing and market research and IT departments. The cause for coordination

problems is often due to the lack of IT support for pricing, forecasting sales, and product profitability associated with new or existing products. In particular, inflexible internal systems and constraints call for a proactive approach to technology. The frictions between IT and business can be explained with the fact that both parties have in most companies different performance measurements. Further, there is usually no common communication level. Understanding is often diametrically opposed. Where product development is talking about business opportunities with new products, the IT department often sees problems in terms of application integration, data ownership (especially about client information), and resources for development and maintenance.

It has to be said that so-called first-mover advantages are difficult to assess. There are few benchmarks accessible in terms of the time it takes to develop a new product before a radical improvement initiative, neither are there statistical data that indicate the length of time it takes from development to commercialization. In praxis, comparisons before and after can hardly be found. Where a new MIS to measure and interpret distribution performance has been implemented as part of the new infrastructure, it will always be difficult to compare product development speed since a firm seldom develops similar products and services twice. On the bottom line, rapid product development and time to market have been objectives for many years in most firms. Various voices from the financial services market stated that it is all about the architecture – how flexible a bank is, how quick a product can be developed in-house, and how quick a third-party product can be integrated into the existing systems. Thus, quick *integratability* will become a crucial competence and key success factor in future. We will discuss the importance of service-oriented architecture as one possible solution later on in this book.

Another assumption that may accelerate time to market and reduce costs for innovations is the development of standardized products instead of tailored individual services. This interpretation, however, might be unrealistic as it is in contradiction to what the sophisticated and demanding clientele expect. Therefore, firms have to find the balance between customization and standardization. To achieve this, one critical success factor for innovation in services may be the firm's ability to create a systematized innovation process and leveraging product platforms across their businesses. We will touch these building blocks of success later on in this book.

Conclusion

We observed that growth is vital for economies and companies and that innovation accelerates growth. Always bear in mind, sustainable growth can only be archived if we continuously monitor the risks associated with innovation and growth strategies. We discussed several routes to innovation and types of innovations. To recapitulate, we broadly divided product and service and process innovation and to a certain extent marketing innovation. Latter combines strategies for sales and distribution channels

in existing and new markets. Marketing innovation also deals with client segmentation, bundling of products and services to value-adding solutions and strategic pricing. Overall, this discipline is in charge for innovative advertising, public relation, and increasingly for social responsibility. The direct drivers for growth are innovations in products, services, and processes. Where product innovation generates high quality and service, process innovations support production, logistics, marketing, and sales. Both affect the efforts to win clients through attractive offerings and quick and reliable services. Innovations in these disciplines lead to higher margins and economies of scale and hence increase the firm's profit. We learned that innovation in services and its processes are different to that in the manufacturing sector. Nevertheless, there are similarities in the interrelation of growth and innovation. We observed that the service sector has recently gone through issues that were negotiated in manufacturing 20 years ago.

To portray profitable growth and innovation strategy in simplified terms, exceptional total shareholder return depends on our capability to understand and align these disciplines. The constant growing of knowledge as a whole as we have experienced it in knowledge-intensive service businesses is appreciably driving growth. Having understood the mutual dependence of knowledge, innovation, and growth, we can now go further and explore the opportunities arising out of the open innovation paradigm. But before addressing that crucial topic, in-depth knowledge about the developments in the market is required. In particular, we need to understand what enabled the shift from a closed to an open innovation paradigm. That is why we explore the major developments in the financial service industry and discuss the implications of the trends identified for businesses in the next chapter before we turn to open innovation.

Notes

1. The value of financial assets expressed as a percentage of GDP can be used to explain macroeconomic interrelations. For example, advances in technology and the deregulation of financial markets around the world have made crossborder capital flows (foreign purchases of equity and debt securities as well as other transactions) possible and given rise to a growing class of global investors. Striking that some 80% of global capital flows involve three regions, namely the Central Europe, United States, and the United Kingdom with average crossborder capital flows within the Euro zone between 2001 and 2005 totaled US \$1.7 trillion. For more on the global capital markets, see McKinsey (2005) "Mapping the global capital markets", *McKinsey Quarterly, Special Edition: Value and performance*.
2. Definition of assets under management (AuM): There are widely differing views within the financial service industry on what the term means. Commonly, it is the total value of assets that a firm manages and administers for itself and its clients. Some financial institutions include bank deposits, mutual funds, mortgage loans, and institutional money in their calculations. Others limit it to funds under discretionary mandate where the client delegates responsibility to the company. The difference between two AuM balances consists mainly of market performance and net new assets (NNA) besides foreign exchanges movements and structural effects of the company. NNA indicate how much money from clients had been newly invested. NNA growth shows the NNA in relation of the previous AuM balance on

- an annualized basis. AuM and NNA growth are an important measure for banks of success and comparison against their competitors, particularly for wealth management businesses.
3. Christensen, C.M. and Raynor, M.E. (2003) *The innovator's solution*. Harvard Business School Press, Boston, MA.
 4. See Boston Consulting Group (2005) *Succeeding with growth: Creating value in banking*. BCG Report.
 5. For the resource-based view on the firm, see the seminal work of Barney, J.B. (1991) 'Firm resources and sustained competitive advantage', *Journal of Management*, 17(1), 99–120 and Wernerfeld, B. (1984) 'A resource-based view of the firm', *Strategic Management Journal*, 5(2), 171–180.
 6. *Hedge funds* are actively managed investment funds that use a wide range of asset classes and strategies such as options or futures that are not usually available to mutual funds and pension funds. Hedge funds are generally open to only a limited range of investors, primarily to institutions and high-net-worth individuals. The objective is to generate returns that are not closely correlated to those of the broader financial markets. The funds managers do not necessarily hedge their investments against adverse market moves. Hedge funds' activities are limited only by the terms of the contracts governing the particular fund. Consequently, many hedge funds have their legal residence offshore in countries unrelated to either the manager, investor, or investment operations of the fund (e.g., Cayman Islands, British Virgin Islands, or Bermuda) with the objective of making taxes payable only by the investor and not additionally by the fund. Fund managers are compensated based on performance rather than as a fixed asset under management percentage fee.
 7. The capital requirement is a bank regulation, influenced by the Basle Committee on Banking Supervision. Within its Basle II capital accord, the framework of a country's banking capital requirements is set and defines how banks and depository institutions must handle their capital. One important measure is *Tier 1* capital that consists primarily of shareholders' equity. It shows a bank's financial strength from the regulator's point of view.
 8. The Morgan Stanley Capital International (MSCI) Frontier Markets Index, launched on November 27, 2007, is reflecting expanded investment opportunities beyond traditional developed and emerging markets. By covering 19 countries, the MSCI Frontier Markets Indices are designed to track the performance of a range of equity markets that are now more accessible to global investors. For further information, see <http://www.mscibarra.com/products/indices/fm/> [January 7, 2008]
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 10. Commission of the European Communities (2003) *Innovation policy: Updating the Union's approach in the context of the Lisbon strategy*. Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee, and the Committee of the regions, Brussels. For more information, see the official innovation and technology transfer page of the European Commission <http://ec.europa.eu/enterprise/innovation/communication.htm> [February 4, 2007]
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 12. Porter, M.E. (1980) *Competitive strategy: Techniques for analyzing industries and competitors*. Free Press, New York.
 13. For the adaptation–imitation theory, see Kirton, M.J. (1980) 'Adaptors and innovators in organizations', *Human Relations*, 3, 213–224.
 14. Kirton's theory has been put into the practical context of banking by Holland, P.A. (1987) 'Adaptors and innovators: Applications of the Kirton adaptation–innovation inventory to bank employees', *Psychological Reports*, 60, 263–270.
 15. Chesbrough, H. (2006) *Open business models*. Harvard Business School Press, Boston, MA.
 16. Schumpeter, J.A. (1934) *The theory of economic development: An inquiry into profits, capital, credit, interest and the business cycle*. Harvard University Press, Cambridge, MA.
 17. The first who conceptualized business process re-engineering were Hammer, M and Champy, J. (1993) *Reengineering the corporation: A manifesto for business revolution*. Harper Business, New York.

18. Marketing innovation has its own tradition based on the seminal work of Levitt, T. (1969) 'The new markets – think before you leap', *Harvard Business Review*, 47(3), 53–67; Levitt, T. (1962) *Innovation in marketing*. McGraw-Hill, Maidenhead.
19. For the term *service*, we refer to the ISO 9004-2 (1991) *Quality management and quality systems element – part 2: Guidelines for services* [Online]. International Organization for Standardization, <http://www.iso.org/iso/en/ISOOnline.frontpage> [November 22, 2003]
20. For a detailed description of what a service is, see United Nations (2002) *Manual on statistics of international trade in services*. Department of Economics and Social Affairs, Series M, No. 86, United Nations Publications, New York.
21. For a description of the characteristics of services, see De Brentani, U. (1991) 'Success factors in developing new business services', *European Journal of Marketing*, 25(2), 33–59; Hill, T.P. (1977) 'On goods and services', *Review of Income and Wealth*, 23(4), 315–338.
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23. For the chaotic approach to innovation, see Quinn, J.B. (1985) 'Managing innovation: Controlled chaos', *Harvard Business Review*, May–June, 73; Mintzberg, H., Quinn, J.B. and Goshal, S. (1995) *The strategy process*. Prentice-Hall, London.
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25. See case study at the Bank of America by Thomke, S. (2003) 'R&D comes to services', *Harvard Business Review*, 81(4), 70–79.
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