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Breaking the rules: Achieving breakthrough innovation in financial services

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Point of view

Financial institutions cannot return to pre-recession return-on-equity levels unless they pursue breakthrough innovation.

> ***"Innovation is the key element in providing aggressive top-line growth and for increasing bottom-line results. Companies cannot grow through cost reduction and reengineering alone."[1]***
>
> *—Making Innovation Work*

Since the financial crisis, financial institutions have focused on cutting costs and boosting efficiency to shore up the bottom line. This approach may yield short-term results, but it won't drive long-term growth and profitability.

The majority of financial institutions* have used conventional means, such as reducing headcount, increasing efficiency, and pursuing mergers and acquisitions, to restore the balance between return on equity (ROE) and cost of capital, and to drive new revenue and profits. In our view, these mechanisms are not sufficient to achieve long-term growth and profit objectives. As illustrated in Figure 1, breakthrough innovation is needed to close this "growth gap."

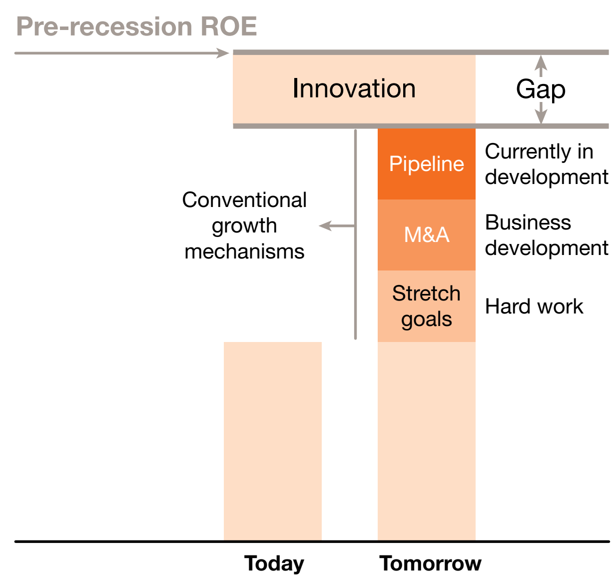
The industry has begun to innovate, with mixed results.

Financial institutions have begun to recognize the need for innovation. For instance, in a PwC survey of the banking industry, 29% of respondents cited "research, development, and innovation" as one of their top three investment priorities.[2] And many institutions have implemented initiatives or even launched dedicated labs to drive innovation. In our experience, however, such efforts alone often fail to deliver significant business results.

Incremental improvements and copycat initiatives won't deliver long-term results.

In our view, a key reason for the lackluster results is that roughly 80% of financial institutions rely excessively on incremental innovation—marginal improvements that focus on "better, faster, cheaper." In addition, many institutions focus on "me too" initiatives, constantly copying the latest trends rather than differentiating themselves from competitors by implementing breakthrough innovation.

Figure 1: For financial institutions, breakthrough innovation is needed to return to pre-recession levels of return on equity.



1 Tony Davila, Marc J. Epstein, and Robert D. Shelton, *Making Innovation Work: How to Manage It, Measure It, and Profit from It: Updated Edition* (New Jersey: Pearson Education, 2013).
2 PwC, "Retail Banking 2020 Survey: Evolution or Revolution?," February 2014, www.pwc.com.

* While many of the concepts we discuss apply broadly to the financial services industry, our focus is on organizations that offer retail financial services, excluding insurance.

The economics of the industry are shifting, and traditional financial institutions face competition from new market entrants, including established technology innovators.

The economics of the financial services industry have fundamentally changed.

Changing regulations are driving down fee revenue and increasing reserve requirements, reducing the profitability of many retail financial products and services.

Customer demand for credit is contracting and is not expected to reach pre-crisis levels until 2020. *One-to-four-family residential loans have declined at a 3% compound annual growth rate over the last five years.*[1]

Banking services are becoming commoditized and technology is lowering switching costs: *9.6% of customers switched banks in 2012, compared to 7.7% in 2007.*[2]

Competition is increasing and includes firms outside the financial services industry.

New entrants are beginning to take market share. For example, *Quicken Loans is now the third largest mortgage provider in the United States, with a 5% market share.*[3]

In this environment, financial institutions must move beyond traditional means of growth and pursue breakthrough innovation to regain and sustain the profit margins of the past.

Technology giants could upend retail financial services.

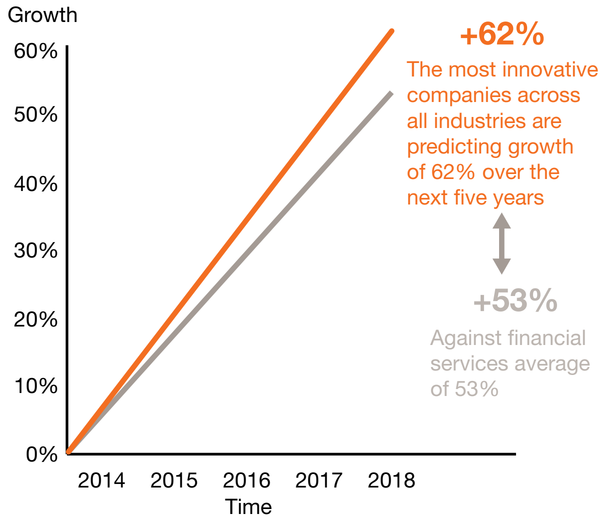
- In May 2013, Google announced it had acquired the existing shares of Lending Club, a peer-to-peer crowdfunding firm, at a $1.55 billion valuation.[4] In the same month, Google Ventures led a group of investors in providing $7.5 million in Series A funding for CircleUp, a leading crowdfunding platform that enables small companies to sell equity to investors.[5]
- Google Ventures also led a $13 million round of financing in Lendup, an online alternative to payday loans, as well as a $17 million round of financing in OnDeck, a platform that provides loans to small businesses.[6,7]
- Google, Inc. has acquired two payment technology startups—TxVia, which offers transaction processing technology, and Jambool, a virtual currency platform developer—for undisclosed amounts.[8,9]

Many believe that such investments could signal the start of an era in which traditional financial institutions face serious competition from established technology innovators.

1 PwC internal analysis using FDIC data.
2 JD Power & Associates, "2012 U.S. Bank Customer Switching and Acquisition Study," February 27, 2012, www.jdpower.com, accessed February 25, 2014.
3 Mortgage Daily, "Biggest Mortgage Providers in 2012," *Bloomberg*, February 25, 2013, www.bloomberg.com, accessed February 25, 2014.
4 Lizette Chapman, "Google Buys Lending Club Stake at $1.55 Billion Valuation," *The Wall Street Journal*, May 2, 2013, accessed on Factiva, February 25, 2014.
5 "CircleUp Raises $7.5M," *Reuters PE HUB,* May 7, 2013, www.pehub.com, accessed February 25, 2014.
6 Cromwell Schubarth, "Google Ventures leads LendUp's $14M Funding," *Silicon Valley Business Journal*, November 12, 2013, accessed on Factiva February 25, 2014.
7 Ken Christensen, "Fast 50," *Crain's New York Business,* October 7, 2013, www.crainsnewyork.com, accessed February 25, 2014.
8 Laura Baverman, "NYC's FinTech Lab proves banks love startups," *Upstart Business Journal,* December 4, 2013, accessed on Factiva February 25, 2014.
9 "Follow Your Entrepreneurial Dream," *Mint Asia,* January 10, 2014, accessed on Factiva February 25, 2014.

Financial institutions must develop a sustainable innovation capability to succeed in a highly competitive arena.

Figure 2: Projected five-year growth rates of the most and least innovative companies across industries.



Source: PwC, "What sets breakthrough Innovators apart: PwC's Global Innovation Survey," September 2013, www.pwc.com.

Ongoing innovation is fast becoming a prerequisite for the success of financial institutions worldwide.

In 2012, PwC launched Project Blue, an ongoing, thorough analysis of trends in the global financial services industry. A primary conclusion is that "businesses that come out on top will have a superior capacity for innovation and constant reinvention."[1]

Given the industry's limited prospects for growth through traditional means, and increasing competition from entrants outside the industry, the need to innovate is urgent. ***In our view, innovation is a primary means of gaining a sustainable competitive advantage.***

Innovation should be more than just a "one and done" success story.

Leading innovators do not view innovation as a one-time "quick fix" but rather as an ongoing approach that will yield lasting results. They may even be willing to incur a short-term loss to achieve a long-term gain.

Investment in innovation has the potential to yield significant quantifiable benefits.

As shown in Figure 2, the PwC Innovation Survey reveals that over the next five years, the most innovative companies (those in the top 20% of innovators across all industries) expect to grow revenue by an average of roughly 62%. Over the same period of time, financial institutions expect to grow revenue by approximately 53%, on average. For a $10 billion financial institution, this translates into a gap of roughly $940 million in revenue at the end of five years.

Innovation also can yield tax benefits. Financial institutions can reduce the after-tax cost of their investments in innovations by identifying and applying tax incentives and credits. They also can benefit from developing tax-efficient strategies for procurement, manufacturing, operations, marketing, and distribution related to new products.

The new competitors

More than half of banks surveyed by PwC (55%) believe that nontraditional players pose a threat to traditional banks.[2] These new entrants are competing aggressively with banks for customers in the areas of deposits, lending, payments, and brokerage services.

1 PwC, "Project Blue: Assessing the future trends for financial services," 2012, www.pwc.com/projectblue.
2 PwC, "Retail Banking 2020 Survey: Evolution or Revolution?," February 2014, www.pwc.com.

Most financial institutions have either failed to embrace innovation or have not fully monetized their innovation investments.

Financial institutions have not fully capitalized on the potential of innovation to help achieve long-term growth and profit objectives. There are many reasons, but following are three that we commonly observe:

Many institutions continue to pursue growth strategies that succeeded in the past, even though the environment has changed dramatically.

Most institutions have grown via mergers and acquisitions or by expanding physical distribution, not through innovation. The ability to develop the right innovation strategy to achieve growth was cited as a leading concern by 26% of financial services executives who participated in PwC's 2013 Global Innovation Survey.[1] Much of the recent innovation in the financial services industry has been pursued by nontraditional players such as Google and Quicken Loans.

Some institutions mistakenly believe that innovation means "following the herd."

These organizations latch onto the same new trends as their competitors, from implementing mobile banking to embracing social media. While these actions may be required to keep pace with competitors, in most cases they are not innovative.

That said, we should note the difference between "following the herd" and a deliberate strategy of being a "fast follower"—allowing competitors to bear the costs and risks of being the first to adopt a new strategy or technology, and entering the marketplace only when the strategy or technology has proven viable.

Even those who value innovation may believe their operations and culture cannot support it.

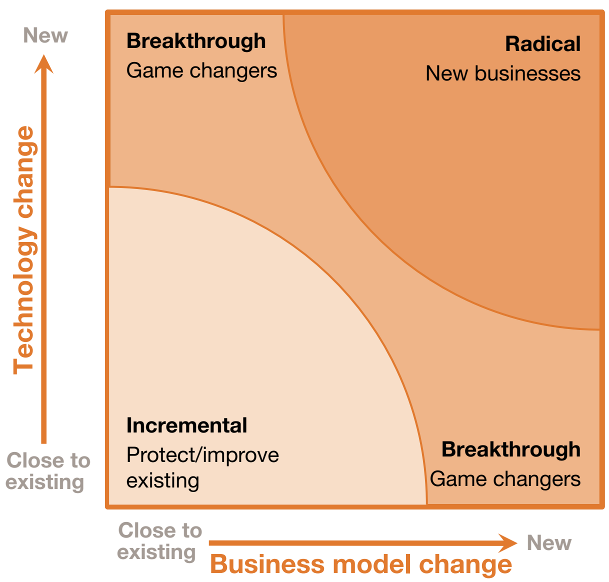
Some financial institutions struggle to innovate because of a perception that the best methods of achieving innovation run counter to how they operate. But the notion that there is one "right" way to innovate is inaccurate. Innovation can exist within individual business units, or it can be enterprise-wide, and it can fit within a variety of operational and organizational constructs.

By understanding that the need for innovation is urgent, and dispelling the myths about what it requires, financial institutions have the potential to achieve the superior business results that most other industries have already realized.

1 PwC, "What sets breakthrough innovators apart: PwC's Global Innovation Survey," September 2013, www.pwc.com.

Success requires the right mix of innovation types, linkage with the business strategy, and management support.

Figure 3: Categories of innovation



Innovation can be grouped into three broad categories:

Incremental:

- Small changes characterized as better, faster, cheaper products and services that do not drive above average revenue growth.

Breakthrough:

- Significant change to the technologies or business model of a product or service that creates significant new competitive advantages and drives above average revenue growth.

Radical:

- Substantial changes to technology and business model. Creates new basis of competition in existing markets (such as new technology platform or cost basis) or creates entirely new markets that provide customers with new value.[1]

Success comes from finding the mix of innovation types to achieve strategic objectives.

In our view, most financial institutions must pursue more breakthrough innovation to achieve their strategic objectives in today's competitive environment.

The innovation strategy must be linked to the business strategy.

An innovation strategy should not be developed in isolation. Rather, it should support the overall business strategy and objectives. Many innovations fail to move beyond the concept stage because they are not linked to the business, and thus business units fail to implement them.

Innovation can succeed at any level of the organization, if it supports the business strategy.

Innovation can be organized in multiple ways, and it can be enterprise-wide or within a department or business unit. Whether centralized or decentralized, developed by a dedicated internal group or dispersed throughout the enterprise, innovation can succeed as long as it supports the business strategy.

Innovation thrives where it is encouraged and rewarded.

Management support is essential to ensuring the success of innovation at any level of the organization.

1 Tony Davila, Marc J. Epstein, and Robert D. Shelton, *Making Innovation Work: How to Manage It, Measure It, and Profit from It: Updated Edition,* (New Jersey: Pearson Education, 2013).

Building an innovation capability requires a new approach, a framework for execution, and the right organizational structure and incentives.

Key success factor: Focus on rapid exploration and discovery

As illustrated in Figure 3, innovation is the process of constant and rapid exploration and discovery. It begins by creating hundreds or thousands of ideas, piloting a handful, and launching the most promising innovations to emerge from the pilots. ***The goal is to test and learn at a high clock speed, driving towards the best possible innovations and minimizing the time and money spent on ideas that are not viable.***

If an organization is lucky, one or a few ideas will succeed. A prominent example is Dyson, which developed 5,721 prototypes in four years before releasing its revolutionary and highly successful cyclonic upright vacuum cleaner.[1]

Achieving breakthrough innovation requires a different approach than other business processes.

While typical business operations are geared to stable, predictable, repeatable situations, breakthrough innovation emerges in situations of high ambiguity, rampant experimentation, and uncertainty. Therefore, building an innovation capability requires a different mentality and management approach than most other business processes.

Success at innovation also requires a clear strategy and effective execution.

In our view, what's needed is a framework for strategy and execution that provides the right tools, processes, organizational structure, and incentives for innovation.

Innovation groups should be insulated but not isolated from the business.

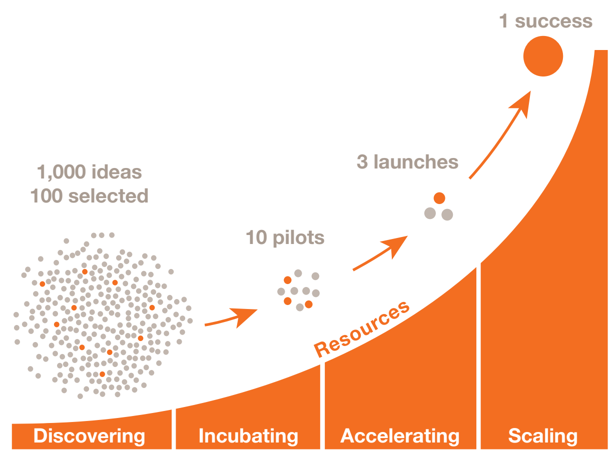
The structure of innovation groups can be centralized or decentralized. But regardless of the structure, these groups should be insulated from the business and given the freedom to do rapid exploration and testing of ideas.

This does not mean that innovation groups should be *isolated* from the business. Rather, they should have free rein to collaborate with internal and external partners to generate and explore innovation ideas that are relevant to the business.

Employees must have the right incentives, or innovation won't happen.

Compensation and incentive systems should be developed to encourage testing of new ideas and to reward employees for achieving innovation objectives—including objectives that cross functions or other organizational boundaries.

Figure 3: Innovation is driven by a process of rapid exploration and discovery.

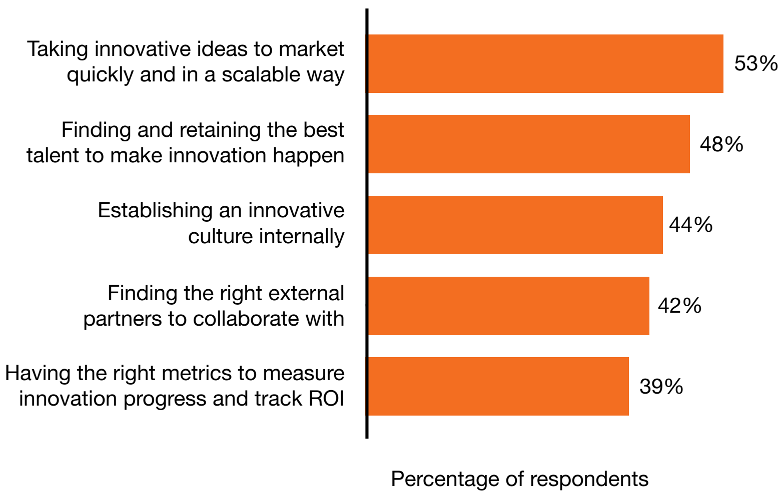


1 PwC, "What sets breakthrough innovators apart: PwC's Global Innovation Survey," September 2013, www.pwc.com.

Financial institutions face many potential obstacles to building a capability for breakthrough innovation.

A PwC survey of 223 financial services executives revealed that the majority of institutions face many of the same innovation challenges. How should they respond?

Figure 4: Top innovation challenges of financial services executives



Source: PwC, "What sets breakthrough innovators apart: PwC's Global Innovation Survey," September 2013, www.pwc.com. Percentage of financial services respondents (except insurance and real estate) citing aspects of innovation are at least "somewhat challenging."

- **Develop a formal innovation strategy** with clear objectives. Senior management should decide what types of innovation are required to meet strategic goals.
- **Assign responsibility** for achieving innovation goals to specific employees, and define innovation initiatives across business units.
- **Design new compensation and incentive programs** that reward employees for achieving innovation objectives that cross organizational boundaries.
- **Explore and prototype at a rapid pace** so time to value can be realized quickly.

- **Develop and implement innovation training,** and make innovation a key consideration in hiring decisions.
- **Hire from the "A team"**—ensure that the best and brightest are focused on innovation.

- **Engage leadership** at the top of the organization and develop an "intrapreneurial" culture to attract top talent—a culture in which innovation is encouraged and rewarded at all levels.
- **Design an innovation organization** aligned with the type of innovation that is desired (different types of innovation must be managed differently).

- **Incorporate partners** from outside of the organization (other financial institutions, companies in other industries, universities, etc.) to help generate new innovation ideas; establish a robust innovation eco-system; and become the partners of choice for developing an innovation strategy.

- **Define clear metrics** and use them to measure progress toward achieving innovation goals. Metrics should provide an incentive for behaviors that align with the innovation strategy.

PwC has designed a framework to help financial institutions establish a sustainable innovation capability.

PwC's framework assists financial institutions in developing an "evergreen" capability for innovation. Our practical, proven approach is based on our deep experience in financial services and on lessons we've learned from institutions that have innovated successfully, and those which have not, across a broad range of industries.

The PwC framework is designed to be tailored to each financial institution and linked to the organization's business strategy. The first two modules focus on defining the organization's business objectives and the role that innovation will play in achieving these objectives. The last two address the missing link in many approaches to innovation: how to execute on the innovation strategy in a way that monetizes the investment and achieves sustainable growth.

A four-stage plan to align corporate objectives and innovation execution

1

Define and align on the business objectives.

What are our business growth goals?

2

Develop an innovation strategy that is aligned with business objectives.

How much innovation do we need?
What types of innovation do we need?
Where should we focus?

3

Design the innovation operating model.

How will we execute the innovation strategy?

4

Execute the innovation operating model.

How can we monetize our innovation investment quickly?

Competitive intelligence

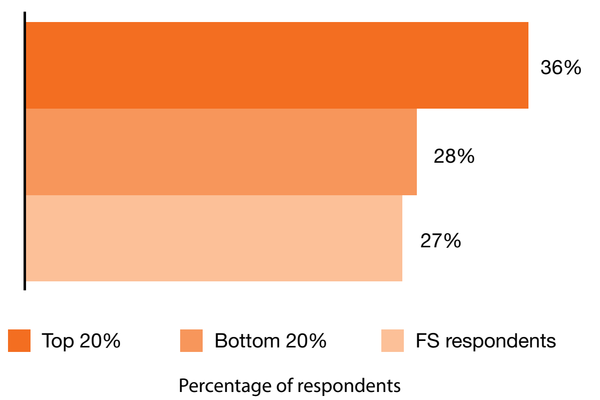
Our observations of industry practices.

Financial institutions fall well below other industries in their ability to manage innovation effectively.

As shown in Figure 5, financial institutions are much less likely than companies in other industries to coordinate and manage their innovation activities for maximum efficiency.

In fact, on average, financial service firms fare about as well as the least innovative companies *across all industries* on this measure, with only 27% of financial services respondents stating that their innovation activities are coordinated and managed for maximum efficiency. We have observed the following reasoning by financial institutions, which helps to explain why the industry lags behind others when it comes to innovation:

Figure 5: A total of 36% of respondents in the most innovative companies stated that their innovation activities are coordinated and managed for maximum efficiency.

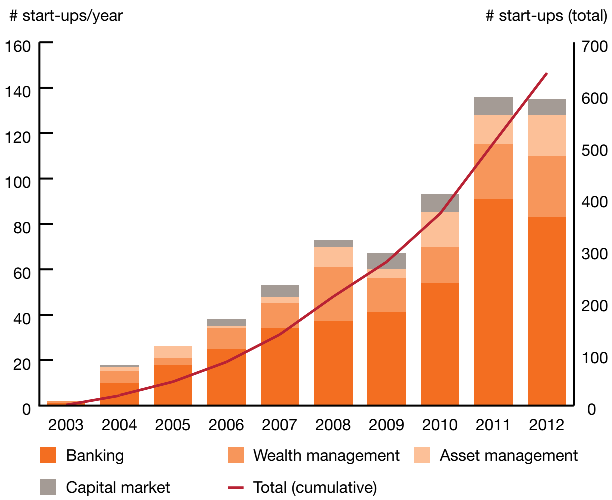


Source: PwC, "What sets breakthrough innovators apart: PwC's Global Innovation Survey," September 2013, www.pwc.com. Calculations are for financial service respondents (except insurance and real estate).

Observation	Overview
Many institutions cite regulatory concerns as an innovation "show stopper."	Financial institutions have been laser-focused on preparing for future compliance. In the process, many have minimized their investment in innovative practices, products, and services out of concern over the potential impact of such innovation or business changes on their regulatory standing. But institutions can innovate without increasing regulatory risk.
Some wrongly believe that innovation requires transformation.	In our observation, some financial institutions avoid innovation because they mistakenly believe it requires a complete transformation of the organization. In fact, innovations can be implemented at any level of the organization, and not all require a major investment. Innovation can involve installing new technologies, or implementing a new operating model, and it can occur at the division or business unit level as well as the enterprise level.
Many organizations fail to implement their innovation strategies.	Many financial institutions focus on developing innovation strategies and spend far less time determining how to execute them. As a result, too many innovative ideas are never implemented. In some cases, the problem is that innovation groups operate in silos. More often, financial institutions lack the required tools, processes, and skills—from market research and prototyping to testing and refining concepts in the marketplace—to implement innovative ideas.

A select few financial institutions have institutionalized an innovation capability. Venture funding of industry startups has also accelerated.

Figure 6: Financial services startups 2003-2012



Source: PwC analysis using CrunchBase.

1 Imaginatik, "USAA: A study in pervasive innovation," www.imaginatik.com, accessed February 28, 2014.
2 Brian Browdie, "Citibank's Innovation Lab Wins Award for Technology Innovation," American Banker, November 29, 2012, www.factiva.com, accessed February 17, 2014.
3 Business Wire, "CitiDirect BE(SM) Mobile wins the Innovation in Cash & Treasury Technology Awards from The Banker," June 4, 2012, www.factiva.com, accessed February 17, 2014.
4 Bank of America, "MIT Media Lab and Bank of America Announce Center for Future Banking," March 31, 2008, www.bankofamerica.com, accessed February 28, 2014.

A few major banks have established innovation labs for exploring and prototyping new products and services.

USAA Open Innovation Lab

USAA developed a dedicated facility that employees can use to promote innovation. The vast majority of employees—95%—actively participate in the company's program to submit innovation ideas.[1]

Citi Innovation Center and Innovation Lab

Citi established a facility to engage the bank's institutional clients in creating more effective products and solutions. The Center leverages new web, mobile, supply chain, and analytics technologies and is fully interactive and global, providing a way to connect with clients, colleagues, and experts worldwide to discuss future needs and collaborate.[2,3]

Bank of America Center for Future Banking

The Center was launched in collaboration with the MIT Media Lab. The goal is to explore new ideas in banking by developing technologies to glean insights into everything from customer interactions to global transactions. The Center leverages mobile banking and social networking technologies to help customers make better financial decisions.[4]

Venture capitalists have accelerated funding of startups delivering innovative retail financial services.

Personal finance

We have seen the emergence of self-driven investing technologies, in response to declining consumer confidence and the need to provide wealth management services to the under-served small investor market. Over the last ten years, 19% of startups in the financial services industry have been focused on personal finance/investing.*

Peer-to-peer lending and crowdfunding

A new frontier of social lending has emerged, with peer-to-peer lending and crowdfunding providing innovative ways to raise capital for new businesses or ideas. In 2012, nearly 10% of industry startups were focused on crowdfunding. Over the last 10 years, 14% of startups in financial services have been focused on peer-to-peer lending and microfinance.*

Payments

From mobile payments to real-time transactions, new payment technology innovations are reshaping the competitive landscape. Over the last ten years, 17% of industry startups have been focused on payments technology innovation.*

* Source: PwC analysis using CrunchBase.

Financial institutions vary widely in the maturity of their innovation capabilities.

Area of focus	Global payments firm	Global commercial bank	Mid-sized regional bank
Linking innovation with the business strategy and objectives.	Created a vision statement and objectives, with a focus on the role of innovation in realizing the vision.	Created a clear and compelling driver for change and identified a role for breakthrough innovation. Objectives were not entirely financial; they included leadership, customer satisfaction, and employee recruitment and retention.	Institution exhibits rampant incrementalism, emphasizing short-term earnings and profit improvement rather than innovations that could drive longer-term growth.
Establishing a culture of innovation, top-down.	Established the culture of a startup with a "can do" attitude—solution-oriented, agile, flexible, quick, with a thirst for revenue and a bootstrap approach. Cultivated an environment of passion for understanding customers' business needs and challenges through sponsorship by an executive innovation council.	Created an out-of-the-box culture of entrepreneurs who are supported by a "blue sky" vision. Leadership supports a strong exploratory orientation, giving employees license to discover innovative ways of doing things that were expected to be commercially viable.	Created an overly constrained culture that was not sufficiently creative or energized to produce breakthrough innovations. The culture is characterized by an excessive focus on "why we can't" do things; a limited sense of empowerment; and frequent changes in direction, funding, and leadership.
Building an innovation eco-system, with the flexibility to experiment.	Established a structured approach to collaborative partnering, internally and externally. Clearly defined partnership goals and implications for the business. The innovation portfolio is designed and managed to provide quick wins as well as medium- and long-term results.	Approached partnerships through explicit goals. Developed partner screening/selection criteria and process. Defined operations guidelines for joint research and collaborative prototype development. The "breakthrough" group was given two-to-three years to commercialize a few projects and provide tangible results.	Used traditional approach to partnering (for example, too slow and bureaucratic, non-collaborative, and with unequal risk sharing). Potential partners did not engage fully and could not provide sufficient value.

Leading On par Lagging

A framework for response

Our recommended approach to the issue.

Implementing PwC's four-step framework can improve the odds of success in monetizing investments in innovation.

A four-stage plan to align corporate objectives and innovation execution

1
Define and align on business objectives.

What are the business growth goals?

2
Develop an innovation strategy that is aligned with business objectives.

How much innovation do we need?
What types of innovation do we need?
Where should we focus?

3
Design an innovation operating model.

How will we execute the innovation strategy?

4
Execute the innovation operating model.

How can we monetize our innovation investment quickly?

Step 1:

Define and align on business objectives.

Clearly defined business objectives will serve as the foundation of the innovation strategy.

The first step in developing the capability to produce ongoing innovation is to define your business goals and objectives, and to gain alignment on these across the organization. These will serve as the basis for developing an innovation strategy and determining the role that innovation will play in achieving business goals. Linking innovation to business objectives increases the odds of successful innovation.

During this step, it is critical to explore a broad range of questions about the internal and external environment, to identify organizational capabilities, goals, and constraints and to determine customer needs and market demand.

Key questions to ask:

- Which of our product and services are most distinctive?
- Which of our products and services are most profitable?
- Which of our customers are most satisfied?
- What is driving market and customer satisfaction and/or dissatisfaction? What are customers’ emerging needs?
- Which of our customers and/or channels are most profitable?
- Which activities in the value chain are most innovative and effective? Are we playing in this space?
- What are our long-term growth and profitability targets?
- What policy, regulatory, and tax rules are affecting us?

Step 2:

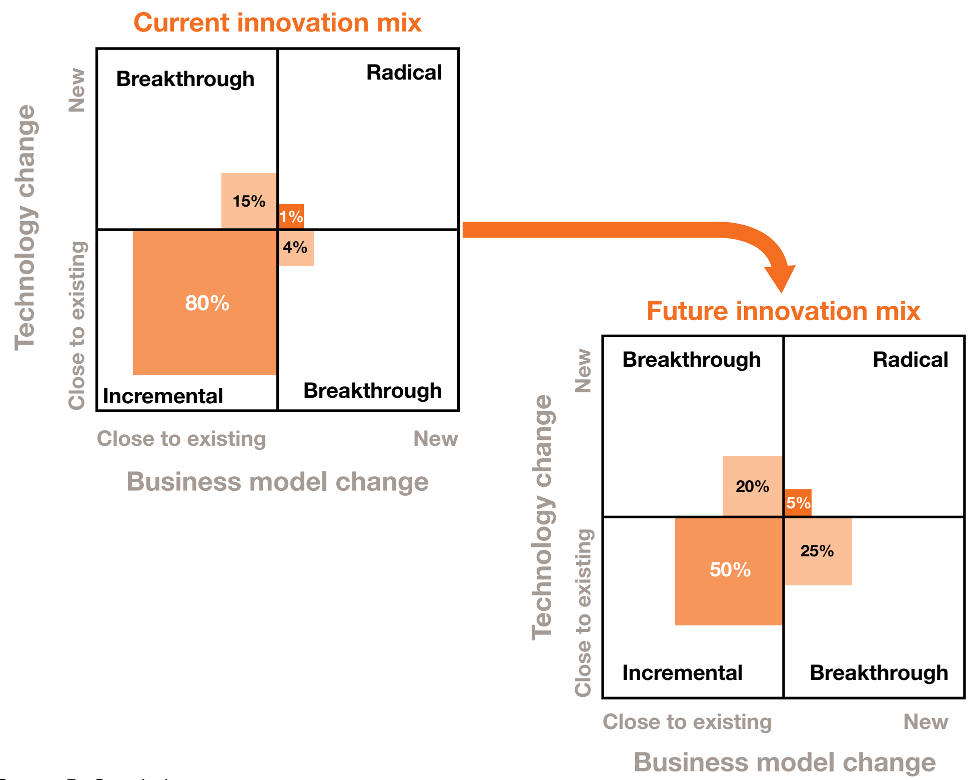
Develop an innovation strategy that is aligned with business objectives.

Determine the amount and mix of innovation types to pursue as well as the areas of focus that will help achieve business objectives.

Based on your business objectives, determine the strategic mix of incremental, breakthrough, and radical innovation to pursue. Financial institutions typically need incremental innovation, to maintain their current products, and breakthrough and radical innovation, in order to grow.

As shown in Figure 7, we observe most financial institutions relying excessively on incremental innovation. Improving the return on investment and meeting strategic objectives may require adjusting portfolios to include more breakthrough and/or radical innovation.

Figure 7: Improving the return on investment and meeting strategic objectives may require adjusting portfolios to include more breakthrough and/or radical innovation.



Source: PwC analysis.

Step 2: (continued)

Develop an innovation strategy that is aligned with business objectives.

Business objectives should drive the innovation strategy.

For instance, if your objective is to be the market leader, breakthrough innovation may be required. If your goal is to be a fast follower, or the environment is highly competitive, incremental innovation may be more appropriate.

Within the context of business objectives, there are other factors to consider:

Determine what's in or out of bounds.

It is critical for senior management to agree on the boundaries of innovation—what is acceptable, and what is out of bounds? For instance, is changing the institution's brand a possibility? Can the technology platform shift completely? Partially? Can the organization radically alter its business model—for example, switching from a product company to a solutions provider?

Decide if you're playing to win—or playing not to lose.

There are two basic innovation strategies:

- The more aggressive strategy, **"Play to Win,"** focuses on achieving a market leadership position through innovation. This appears to be the preferred approach for the most innovative 20% of the organizations that participated in PwC's 2013 Global Innovation Survey.
- The more conservative strategy is **"Play Not to Lose."** Institutions that apply this defensive strategy strive to avoid being blindsided by a competitive move. This strategy can be appropriate under certain circumstances, such as when the environment is highly competitive or the institution does not desire to be the market leader and prefers not to take major risks.

Pursue multiple innovation strategies.

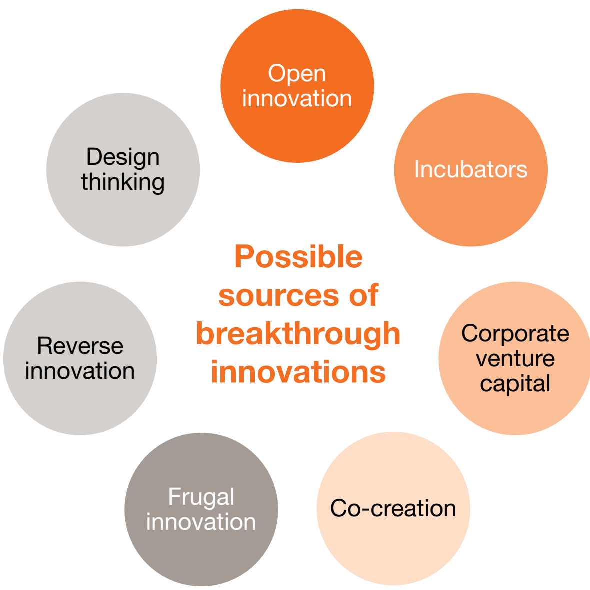
A single institution can and should support a mixed innovation portfolio. Leading innovators take this approach, applying different innovation strategies to different business units or product groups.

For instance, a bank might pursue incremental innovation in its mortgage products and breakthrough innovation in its deposit products. Or, a financial institution might focus on incremental innovations for older customer segments and radical innovations to attract a younger demographic.

Step 3:

Design an innovation operating model.

Figure 8: Seven operating models have proven likely to generate breakthrough innovation.



The following seven operating models have proven likely to generate breakthrough innovations, which industry leaders have used to generate a competitive edge. Financial institutions should select and implement one or a combination of these models:

Incubators: Incubators are akin to startup companies but are embedded in the organization. Employees in these dedicated innovation groups (also sometimes called innovation labs) are free to explore and prototype new business models and/or technology. They act as entrepreneurs while leveraging the resources of the larger organization.

Open innovation: This model includes outside collaborators in developing innovations. This reduces the cost of innovation compared to traditional R&D, while giving the organization access to a broader range of skills and expertise.

Co-creation: This model brings customers onto innovation teams, rather than simply observing them or soliciting their opinions. Co-creation tends to stimulate new thinking and generate novel outcomes.

Design thinking: Under this model, the organization gains insight from careful observations of users as they engage with a product or service. Like incubators, this model stresses rapid prototyping to test innovation concepts.

Corporate venture capital: Organizations invest in early stage startup companies to acquire intellectual property. This model is particularly effective for organizations that want to gain knowledge rapidly in new areas where the target startups have a head start.

Reverse innovation: This model is used to generate innovations in less developed countries. Rather than adapting western innovations for these countries, innovation is built from the ground up, based on meeting local needs. Once innovations are successful in one country, they are adapted and scaled for global use.

Frugal innovation: The philosophy behind this model is "less is more." It advocates simple, durable products that are easy to maintain, energized by the presence of constraints.[1]

1 Tony Davila, Marc J. Epstein, and Robert D. Shelton, *Making Innovation Work: How to Manage It, Measure It, and Profit from It: Updated Edition,* (New Jersey: Pearson Education, 2013).

Step 4:

Execute the innovation operating model.

Once the operating model is in place, institutions should mobilize to implement the model and monetize their investments quickly.

Metrics and motivators are essential to monetizing investments in innovation. However, for metrics and motivators to be effective, they must coexist with the right organizational structure, the right culture, and continuous learning to drive the innovation process forward.

Figure 9: Metrics and motivators are essential to monetizing investments in innovation.

What role does management play in encouraging innovation?
Does the recruiting strategy support innovation goals?

Does the culture favor valuable change?
Does the physical and operational environment support innovation?

Is leadership providing guidance on what types of innovation employees should seek?
How to create value?
What great innovation looks like?

Are there systems in place to help the institution get better at innovating—including systems for building capabilities, crafting strategy, and learning from failures?

The inside scoop on metrics and motivators

Metrics

In our experience, metrics are one of the most undervalued success factors in making innovation work. Innovation requires an integrated set of measures, including metrics for:

- Innovation inputs—for example, how many resources are we dedicating to the innovation effort? How effective is the innovation structure, such as interest groups, training, and access to external partners?
- Innovation process—what is the quality of our innovation pipeline? How much time is needed before projects begin showing returns? How are project risks being managed?
- Innovation outputs—have new processes resulted in cost reduction as promised? Have product ratings improved?
- Value generated—have total sales grown? How has profit been impacted?

Motivators

Incentives should be designed to support and encourage innovation. Institutions need to think about how to reward employees for taking risks and encourage them to think outside of their job descriptions. Usually, financial incentives are only part of the answer.

How PwC can help

Our capabilities and tailored approach.

PwC Advisory

We look across the entire organization—focusing on strategy, structure, people, process, and technology—to help our clients improve business processes, transform organizations, and implement technologies needed to run the business.

Client needs	Issues we help clients address
Innovate and grow profitably	• Developing and executing on innovation strategy. • Transforming business information to drive insight and fact-based decision making. • Evaluating acquisition and divestiture strategies to position for the future.
Manage risk and regulation	• Building a risk-resilient organization. • Managing enterprise-resource-planning investment and project execution risk. • Safeguarding the currency of business; keeping sensitive data out of the wrong hands. • Providing capital project governance and accountability.
Build effective organizations	• Establishing effective strategic sourcing and procurement. • Realizing competitive advantage through effective sales operations inventory planning. • Transforming the close and consolidation process to work for you rather than against you.
Reduce costs	• Driving efficiency through shared services. • Redesigning finance to realize efficiency and competitive advantage. • Taking control of cost through effective spend management and cash forecasting practices. • Developing a tax-efficient strategy for procurement, operations, marketing, and distribution. • Identifying and applying tax credits and incentives.
Leverage talent	• Defining and implementing an effective human resource organization. • Rethinking pivotal talent. • Designing or enhancing human capital strategy to attract talent and reward innovation.

What makes PwC's Financial Services practice distinctive.

Integrated global network	With over 34,000 industry-dedicated professionals worldwide, PwC has a network that enables the assembly of both cross-border and regional teams. PwC's large, integrated global network of industry-dedicated resources means that PwC deploys the right personnel with the right background on our clients' behalf whenever and wherever they need it.
Extensive industry experience	PwC serves multinational financial institutions across banking and capital markets, insurance, asset management, hedge funds, private equity, payments, and financial technology. As a result, PwC has the extensive experience needed to advise on the portfolio of business issues that affect the industry, and we apply that knowledge to our clients' individual circumstances.
Multidisciplinary problem solving	The critical issues financial institutions face today affect their entire businesses. Addressing these complexities requires both breadth and depth of experience, and PwC service teams include specialists in strategy, risk management, finance, regulation, operations, and technology. This allows us to provide support to corporate executives as well as key line and staff management. We help address business issues from client impact to product design, from go-to-market strategy to an optimized economic model, to proper functional practices across all aspects of the organization. We excel at solving problems that span the range of our clients' key issues and opportunities, working with the heads of the business, risk, finance, operations, and technology operations.
Practical insight into critical issues	In addition to working directly with clients, our practice professionals and Financial Services Institute (FSI) regularly produce client surveys, white papers, and points of view on the critical issues that face the industry. These publications—as well as the events we stage—provide clients new intelligence, perspective, and analysis on the trends that affect them.
Focus on relationships	PwC firms provide industry-focused assurance, tax, and advisory services to enhance value for our clients. More than 184,000 people in 157 countries in firms across the PwC network share their thinking, experience, and solutions to develop fresh perspectives and practical advice.

Appendix

Select qualifications.

Managing and executing innovation strategy—Major retail bank

Issues	A major retail bank recently established an innovation lab to drive improvements in products, services, and processes. For this newly established unit, the bank was seeking leading practices in innovation strategy and execution to incorporate into its go-forward operating model.
Approach	PwC helped define four key components for better managing innovation across the bank by: • Developing the innovation lab's idea evaluation framework and process. • Articulating key metrics for assessing the risk and success of implemented ideas. • Conducting a global competitor review on innovative practices in financial services to inspire idea generation. • Developing key recommendations on establishing an innovation operating model and culture for the bank.
Benefits	The bank made a dedicated investment towards establishing an innovation team, and PwC's recommendations enabled the bank to develop a more disciplined and structured approach to its innovation strategy and execution. These recommendations included defining innovation objectives that aligned with the bank strategy, implementing a more structured and efficient process for idea management, and developing an innovation operating model that would drive greater collaboration and sponsorship of innovation across the bank.

Innovation strategy and operating model—Global payments firm

Issues	A global financial leader in payment services faced significant changes in the industry, including the shift to a more consumer-centric model, an ecosystem with players in flux, and an increasing focus on mobile services. In addition, there were several new entrants in the industry—nontraditional players with high-clock speeds of innovation focused on disintermediation of legacy providers.
Approach	PwC's innovation strategy approach included conducting an assessment of the client's "as is" strategy and operating model, comparing them with leading practices in breakthrough innovation, and identifying key gaps across strategy, people, processes, and technology in order to help the client generate an innovation strategy that addressed competitive threats and market opportunities. Based on the results, the key deliverable was an innovation strategy that addressed the client's competitive threats and market opportunities. PwC also designed a blueprint for the future breakthrough innovation capabilities, including process, resources, culture, and governance.
Benefits	Bringing an external perspective and knowledge of leading practices in innovation strategy across markets, PwC provided the client an innovation strategy that was aligned with the organization's business objectives, was approved by senior management, and was sponsored for pilot execution.

Collaborative innovation strategy—US-based online brokerage firm

Issues	A large broker dealer was running short of innovation ideas for its multitude of trading platforms and wanted to tap into external creativity and skills to refill its innovation pipeline.
Approach	In working with PwC, the firm created a community of customers and external developers to generate new innovation ideas for the platforms, vote on their favorite ideas, and create prototypes of the top ideas for implementation in the trading platforms.
Benefits	In only two months, hundreds of participants generated more than 450 ideas and created 45 prototypes of the top 10 ideas. Many of these ideas are currently being implemented in the trading platforms, and the company has continued to engage this community to produce innovations in other areas of the business.

Innovation strategy and execution—Major retail bank

Issues	A major retail bank identified the need for a focus group to help identify, define, and pilot ventures that might prove disruptive to the financial services industry. A chief innovation officer was named and a high-level process was outlined to articulate and receive funding for ventures. The team used an ad-hoc process to identify and receive funding for two initial ventures, but recognized a need for a more robust framework to guide their future efforts in a consistent, scalable manner and enable them to serve as innovation evangelists across the company.
Approach	During the course of the engagement, PwC worked collaboratively with the bank to: • Articulate and document a framework to drive the ideation and execution of disruptive innovations as well as to explain the role of innovation to employees throughout the bank. • Identify key questions and develop a prioritization model to help assess and rank ideas for further funding and development. • Make future-state recommendations outlining roles and responsibilities, tools and techniques, and supporting capabilities required to consistently deliver high-value innovations. • Conduct an assessment of two previously funded ventures to identify opportunities to enhance transparency and risk mitigation. • Support delivery of previously funded ventures by implementing project-management discipline.
Benefits	The bank's innovation team brought new transparency into the ideation process and built strategic support for the group. The process became scalable, allowing more innovations to be identified, defined, and funded by the venture board. With project management discipline, the innovation team defined, implemented, and enhanced execution of funded ventures, increased transparency and improved risk mitigation and issue resolution.

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"Breaking the rules: Achieving breakthrough innovation in financial services," PwC FS Viewpoint, April 2014, www.pwc.com/fsi.

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