Natural Innovation: A theory of innovation for larger firms in financial markets

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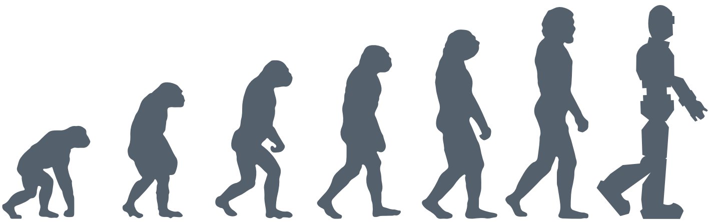
Financial markets are awash with innovation – new fintech funding stories make the headlines every day. As a result, many of the established players have been forced to sit up, listen and worry about how they might suddenly get 'uber-ised' by some upstart coming straight out of left field. This had led many to create innovation labs, incubators, startup committees and other bureaucratic paraphernalia to try and beat the fintech challengers at their own game. But the odds in the fintech stakes seem to favour the little guys. After all, they come armed with nimble business models and are unencumbered by legacy technology, clients or process. But is that really the case?

In this paper Steve Grob looks at how larger firms can, and are, shifting the odds back in their own favour with a different approach; one that borrows ideas and thinking from the most creative, innovative process of all time.

The ultimate innovator

The most effective form of innovation can be seen all around us, every day. Charles Darwin taught us that any random mutation that favours a particular species' survival is automatically selected and makes it through to the next round of evolution. This extraordinarily simple, yet powerful, construct has led to an unimaginable variety of species that can solve almost any problem, often in the most simple and elegant manner.

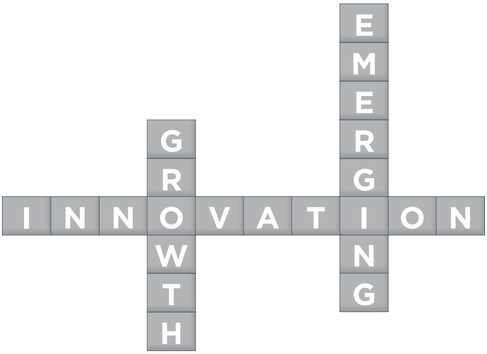
Nature, then, when powered by natural selection, is the ultimate innovator.



Mother Nature cheats, though, because she gets to bet on every option and the currency which she uses to place those bets, time, is in unlimited supply. Nevertheless, some of the deeper principles and implications of natural selection are allowing the more forward thinking firms to turn the tables on their smaller competitors.

Before we look at this in more detail, let's first explore the challenges involved in successful innovation and how, at first glance, the odds really do seem stacked in favour of the smaller players.

The rules for winning in innovation



Most innovation focuses on either emerging or growth categories. The difference between the two is that an emerging category is still seeking universal acceptance of its legitimacy (e.g. Blockchain), whilst a growth category, already acknowledged as a legitimate space, has nowhere near reached mass adoption (e.g. derivatives post-trade automation). Both are typified by the fact that there is no leader that dominates the supply in that particular category and so the race is on. The winner gets to exert pricing power in their chosen category, whilst the losers will become increasingly marginalised or even forced to move to less profitable terrains. This leads to a struggle of almost primeval technical and commercial savagery. It is played by two rules that are summed up well by Geoffrey A. Moore in *Escape Velocity*:

1. Must be present to win (you have to be in the race to win, regardless, which leads to the codicil rule of 'go ugly early'); and

2. Best offer carries the day (which is fundamentally a deployment strategy that vows not to lose the deal, regardless)

These two rules, however, are hard to follow for many large firms which, by nature of their success, operate to almost opposite principles:

1. Brand reputation is vital (which leads to a "it will be done when it's ready" approach); and

2. Maximise customer revenues (i.e. "we've earned the right to maximise our returns from our hard won and well cared for customers")

Small firms have the advantage here as they are able to develop and deploy product faster (often this may be no more than just advanced prototypes) and then iterate and improve upon them on site. Also, customers tend to be more forgiving of their smaller, new suppliers than they are of their established partners from whom they expect every shipment to work first time, every time.

Smaller firms have greater flexibility commercially, too, as they operate from smaller cost bases and are prepared to fight – almost literally – as if their lives depended upon it. Conversely, selling into emerging or growth categories does not come easily to established firms. Their account managers are naturally more focussed on maximising each customer relationship over the long term. Smaller companies simply don't care about this because if they cannot win in the here and now, nothing else matters.

Faced with these conundrums, the natural reaction of many large firms is to try and play better or harder at the rules. Unfortunately, this is completely the wrong thing to do.

The first knee-jerk reaction is to go and acquire small, innovative firms and so capital markets are littered with stories of small, highly innovative firms that have been acquired by larger ones. But the results have generally been disappointing as the small firm's great technology often gets swamped by the daily operating and commercial rules of the acquiring firm. Almost by magic the innovation, alternative thinking and dynamism gets sucked out of these firms overnight and all that is left is disgruntlement on both sides.

Innovation committees, incubators and labs are another approach, but these can suffer a similar fate too. As soon as an idea is conceived and brought into 'real world' operating conditions, it is all too easily strangled by the bureaucracy, rules, process and generally diminished risk appetite that is essential to keep the established business lines operating well. New ideas are simply not mature enough to fight for scarce resources against established business lines that, by definition, have learnt to play the corporate game effectively.

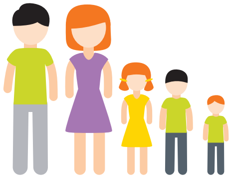
A third approach is to set up separate investment businesses to provide finance to new firms. Whilst this can work well, it indicates a corporate shift into venture capital which is a domain that operates with a very different risk/reward dynamic that may not fit well with the higher corporate goals of the organisation.

The solution for larger firms, then, lies in playing by entirely different rules. Rules that favour scale and that can amplify the natural advantages of the big guys.

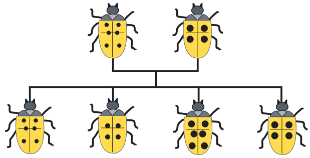
Natural innovation

Pretty much all industries have to operate within a set of regulations that are aimed at ensuring the proper functioning of the underlying market. Nowhere is this truer than in finance which operates within one of most convoluted and changing regulatory environments. This is compounded by the fact that, despite being a globally intertwined business, it has multiple regulatory bodies opining on market structure and participants' behaviour.

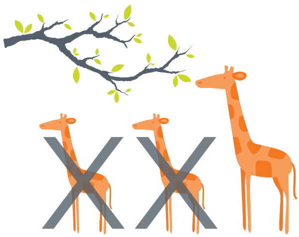
The governing principles of natural selection



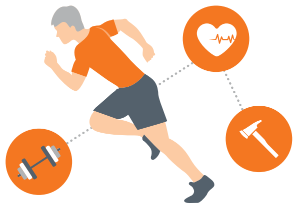
1. Variability



2. Inheritance



3. Selective Pressures



4. Fitness and Survival of the Fittest

Winning in a fintech emerging or growth category is a particularly daunting prospect, then, and it is this fact that enables large firms to leverage Darwinian principles of natural selection to their advantage. Key to this is adopting a principle of self-directed evolution which allows firms to increase their chances of being successfully innovative.

So what are the rules for 'natural innovation' and how can they be applied in today's world?

Patience

Contrary to popular belief, eureka moments are rare. In fact, studies show that innovation rarely comes in a blinding flash of insight, but more often as the result of a steady stream of improvements that follow a hunch or gut instinct otherwise known as simple intuition. So innovation actually is a function of sheer effort and resource – something that should immediately place larger firms at an advantage. As mentioned earlier, natural selection takes this to extremes and bets on every outcome – a luxury beyond the practical realities of business.

Nevertheless, many large firms have a huge number of formal and informal innovation initiatives underway across their businesses. And yet it is surprising just how uncoordinated these efforts actually are in many cases. This is because innovation is part of every business process and so initiatives tend to spring up in haphazard ad-hoc ways, with different objectives, different methods and different reporting lines. On top of this, and somewhat ironically, innovation can often be seen as something that just gets in the way of the daily running of the business and so all too easily gets marginalised.

Without change there can be no innovation

The title of Richard Dawkins' book, The Blind Watchmaker, says it all. Nature doesn't have an ultimate objective, she simply wants to make things better. Key to this is having as many throws of the evolutionary dice as possible and this is just as true for promoting natural innovation in larger firms. The trick, though, with only limited dice throws available, is knowing when and where to throw them.

A good starting point is to look at where the interaction with your customers is most frothy as this often indicates dissatisfaction with the status quo on one, either or both sides. Another is to look at new areas adjacent to the current business, whilst a third, although less dynamic approach, is to look at new entrants into a relevant market.

What is then needed, as in nature, is a mechanism to simplify, direct and focus these efforts in order for large firms to leverage their size and resources. Key to this is communicating these directions of travel repeatedly to all parts of the firm. This allows the varied innovation activity dispersed around the firm to coalesce around a small number of goals so that their combined expertise can be amplified. It is equally vital, therefore, that these different groups are in regular contact with each other. The sad truth, however, is that in many cases they are not even aware of each other's existence.

In this way, a firm might decide that its key directions of travel are a new asset class, a new area of workflow or the application of a specific new technology to an existing business line. This drumbeat can then be picked up by the firm's technical, commercial and business thinkers and turned into incremental, innovative - yet directed - evolution. This approach allows self-direction to come into play, but without interfering or trying to bully the delicate innovative process itself.

Having decided on the directions of travel it is essential to try and think concurrently about all aspects of the problem domain - new technical approaches, deployment strategies and commercial models - rather than force new ideas through existing constructs. Perhaps counter-intuitively, simply asking for things to be done differently is a great way for large firms to boost innovative progress in these areas. Smart people work for large firms too, and so by allowing them to work unconstrained when it comes to innovation, they can be just as insightful or creative as their peers in the Silicon Valleys, tech roundabouts and other such hangouts.

Nature doesn’t care where innovation comes from

Many large firms think of innovation as something they either do themselves or buy in through acquisition. And yet nature is full of symbiotic relationships where two seemingly diverse species find a way to cooperate to their mutual benefit. These relationships are strong and enduring because they work better at solving a problem than either could on its own and so provide an evolutionary shortcut to more efficient or better outcomes. The global finance industry is ideal for this type of cooperation as it throws up significant compliance, brand, information security, regulatory and other highly challenging barriers to small firms seeking to make headway. These are all issues that, by definition, the large dominant firms will have satisfactorily solved for already.

This theme was explored in my previous paper, Innovation Ecosystems, in which I discuss how large firms can create a lens that focuses innovation on their established customers and so is an essential aspect of the naturally innovative firm. Key to their success is to avoid the tendency to become precious about innovation or where it comes from. If a new idea works and improves the customer experience, then that is all that should matter. This is especially true of emerging or growth categories as shipping early is vital. It may also be that the category turns out to be less glamorous than at first thought, and so whilst this is a less desirable outcome, it is better for both parties to discover this early and move on to other projects.

Rewarding success and failure

Mother Nature has plenty to teach us about rewarding success and failure. All too often in large firms, new business ideas that fail either tarnish their owner’s reputation or, worse still, are dressed up as ‘successes’ in order to appease senior management.

Mother Nature is ruthless in condemning failure but she doesn’t measure it with spreadsheets, quarterly sales forecasts, shipment units or the other metrics executives use to run existing business lines. Instead the measurement is far more subtle, more qualitative and, crucially, happening all the time. The lesson here is that the measurement for success of any new innovation needs to be performed more regularly and focussed around the dynamics of what is happening across the complete category. Yesterday’s competitor maybe tomorrow’s customer or partner in the fast-moving world of emerging and growth categories. Winning requires flexibility.

Obviously winning in business overall is just as much about execution as it is about strategy and execution requires precise measurement in order to be effective. The trick is in treating those areas previously identified as “directions of travel” differently, by being prepared to try, to fail, to change course and then to try again.

Goals and targets for innovation do not have to be woolly, but they do need to be more incremental and reviewed more regularly along the journey. For example, “grow sales by x percent per quarter” or “reduce operating expenses by y percent” are fine for established business lines, but they won’t work for innovation. So, “prove the efficacy of the core business idea to 5 potential customers” or “build a prototype in a new technical infrastructure” might be better targets. This highlights another challenge of innovation in large firms. Because it is not associated with the same rigorous metrics, it can all too easily become trivialised or seen as somehow not being part of the real business. In fact, the opposite is true, as without innovation no organisation can continue to dominate.

Just as in nature, some new ideas will fail. In fact more will fail than succeed which is why a granular approach works best. Knowing whether an idea has failed or not is particularly difficult with innovation, but if the directions of travel have been set correctly, then in some sense there is no failure, just steps on the journey.

Conclusion

Just because a firm is small it doesn’t mean that it is inherently better (or even good) at innovation. And yet the traditional rules of successfully deploying new fintech do seem to favour smaller firms. Rather than try to beat the little guys at their own game, however, there is another approach for larger firms that operates with different rules and reflects some of the unique challenges of the financial markets industry. These borrow from the principles that make natural selection such a powerful, innovative force and allow large firms to leverage their weight and resources.

Only time will tell if ‘natural innovation’ will prove to be the answer for larger firms, but it does offer an approach that plays to their strengths rather than those of the fintech newcomers.