The Innovation Killing Bank
by Charles Wendel

At many banks innovation in the SME space and elsewhere is dead. Bankers may throw the innovation word around, and a few may actually practice it, but in most cases the reality is drastically different from a bank's self-delusional marketing gloss. One client even commented that his bank was an "innovation killing machine." Why?

Fear dominates. A head of retail at a regional bank was listing the compliance and regulatory issues he was worried about. I commented that he seemed almost paranoid. His response was, "I am paranoid." Fear seldom results in innovation; rather it creates a hedgehog-like mentality in which the goal of preservation dominates.

No room for error. Most bankers believe that it is in their own best personal interest (but not necessarily their bank's) to do nothing rather than make a mistake: "One mistake you may survive; two, and you are out." A "mistake" can be a marketing initiative that does not pay off or a new product that fails to catch on. Having a sword over your head means you tend not to stick your neck out.

More rules and checks are best. That attitude of fear and trying to focus on CYA slows decisions and results in complex and Byzantine decision processes. For example, alternative lenders trying to respond to a big bank's RFP for a possible partnership need to address 400 questions from the bank generating the RFP. That shotgun like approach suggests a self-indulgent bank management that is also clueless about what it wants to accomplish. Obviously, speed and getting things done takes a back seat to other concerns. Due diligence is appropriate, but 400 questions?

Defensiveness versus self-realization. During a recent bank project several line bankers detailed problems with its central credit process related to speed and lack of transparency. When I gently broached this topic with the head of the credit group his reaction was immediate and fierce. His support group was not the problem; rather, it was the line that was making errors, and he would meet with them to detail their mistakes. Rather than hearing what others said and taking the opportunity to develop an innovative solution, he immediately circled the wagons and became aggressive.

Regulators are running amuck. Banks certainly made mistakes at the end of the last decade. We had the opportunity to see some of the bad loan decisions they made when we worked on FDIC Shared Loss deals for acquiring banks. Many banks, in particular the biggest, deserve increased regulatory attention. However, the industry does not deserve to be emasculated. Sometimes regulators seem to be playing a game of whack-a-mole. Every time banks come up with potentially profit generating ideas…WHACK! The regulators come in and tell the banks why their profit path cannot be traveled without venturing through some rocky and opportunity-killing terrain.

We know one bank that quickly chose an alternative lending partner. A year later they were still trying to close the deal as they dealt with regulatory issues that seem to increase each week. Of course it is fair for the government to ask questions, but their actions undermine valid profit initiatives.

Unfortunately, the response of the banking industry to often feckless regulatory actions has been inadequate. Bankers are unwilling to challenge stupid rules in part because they fear the wrath of the unrestrained bureaucrat. When non-bank lenders or payment companies innovate and challenge traditional approaches, some bankers indicate their inability to compete in the marketplace by suggesting that the new competitors should be burdened by the same constraints that have restricted them.

While to some extent regulators need to be controlled, many bank executives have become comfortable with the handy excuse that regulators provide for justifying inaction and mediocre returns: "The regulators won't let us do x."

The line has surrendered. At most banks, 20 years ago the line was king. Support groups were subservient and expected to serve the needs of the revenue producers. One past client engagement focused on improving a bank's SME performance tells the tale. As part of a bank tour on the project's first day we asked to meet the credit and operations staff. We found they literally sat in the bank's windowless cellar, an indication of their lack of power versus the line with their sun-filled offices.

Now, that imbalance seems to have swung back in the other direction. At more banks the "power" rests with support groups like Credit and Risk, IT, and Marketing. And, of course, the greatest growth area for many banks is Compliance. The support groups are not to blame for this change. The line bankers made lending mistakes, compromised a bank's performance, and lost their internal credibility. And, again, once the horse left the barn door, regulators demanded changes so that the mistakes of the past would not be repeated. (In this increasingly asynchronous world other mistakes are likely to occur undetected.)

Negative people. Recently, the press has told the tale of some issues with Lending Club and its founder. One ex-banker took the opportunity to exclaim in the *American Banker*, "I told you so." Somewhat pitifully, lots of bankers have been looking forward to problems with alternative lenders and other innovators. Somehow innovators experiencing problems justifies their own lack of creativity and willingness to push in new directions. Years ago, Tom Peters, one of the most challenging consultants of his era, wrote (to paraphrase) "Do you want your tombstone to read, 'He was mediocre." Apparently, some bankers do.

Despite all, innovation does exist. Fortunately, examples of bank innovation in the SME space exist in the U.S and elsewhere.

- *Wells Far*go, probably the innovation leader among the biggest banks, is using its small business expertise and analytic capabilities to respond to inroads by alternative lenders by creating a product that matches and/or exceeds what those lenders offer.

- *Live Oak,* an Internet bank housed in North Carolina, has been achieving substantial growth by focusing on SBA lending as well as specializing in a number of industry segments.

- *Eastern Ba*nk, a $9B Boston bank that seems to hit above its weight, through its Eastern Labs is travelling a very different path than most mutual banks.

- *Regions Bank's* venture with Fundation reflects a bank's management's willingness to take an honest look at its strengths and reach out to work with a company with which it can cooperate rather than compete.

- *Chase* and On Deck provides another example of a similar frank self-assessment and a bank's willingness to partner up when it finds the need.

No surprise that in each of the above cases, innovate begins at the top…but can often die there.