

Reshaping Innovation in The Romanian Banking System

by

Eliza Laura Coraș, Horatiu Regneala

The Bucharest University of Economic Studies, Romania

eliza.paicu@yahoo.com, regnealahoratiu@gmail.com

Abstract: This paper draws on the challenged banking system to maintain profitability under an extremely unfavorable environment, focused on quantitative targets and increasing competitiveness. While the most powerful force that is currently reshaping the banks goals is increasing customers' expectations, banks reach to all internal and external sources of innovation. The purpose of this paper is to build the argument of a strong innovation culture as a response of banks to the market demand. We also refer to an innovation risk management framework that blends an effective risk management strategy with sound innovation practices. Using risk management processes to improve the innovation capabilities represents a field of study little explored in the current literature. We locate our study on the Romanian banking system, using the insights gained from key managers from three large banks, invited at expert group meetings. The research carried out was exploratory and the cases were chosen because of their relevance for the current innovation landscape in the banking sector in Romania. The results were indicative for three major variables to be positively associated with the development of a viable innovation risk management framework: intrapreneurship, technology and resources. Our study is suggestive of a business model that banks apply lacking a formalized innovation strategy culture, requiring a rapid shift of strategic forces.'

Key words: innovation risk management, innovation strategies, innovation culture, risk management, banking system.

JEL classification: G21, O31

1 Introduction and scope of research

A large body of literature starting with Schumpeter (1911) argues that finance leads to economic growth, because the services that the financial sector provide allow capital and resources to be allocated to the highest value use with reduced risk of loss caused by adverse selection, moral hazard, or transaction costs. (Hsu et. al, 2014). Innovation stands as the pillar of the growth of the financial sector. Banks innovate to increase the efficiency of the production of financial services as well as the quality and variety of financial products. As a result, innovative banks can more effectively screen loan applicants, offer services at lower costs, and more efficiently intermediate between liquidity demand and supply (Bos, Kolari and Lamoen, 2013).

Moreover, technology is the variable the boosted innovation in finances. The client is the other variable that defines the strategic goals of the financial companies. Together, these forces constantly reshape the current banking environment. Accenture believes that the industry leaders are moving inexorably towards

a fresh and differentiated vision for banking: the 'connected and digital bank'—a new type of banking organization in which business and technology are more closely aligned to create a new experience for customers as their everyday bank. The connected bank is an integral part of its customers' ecosystem, engaging and interacting with them digitally and socially through multiple integrated channels (Moreno, Pichler and Starrs, 2014).

Financial institutions are under pressure to produce returns in an extremely unfavorable environment, which increases the risks they need to overcome. In the current global economic context, financial institutions are challenged by a market in which growth it proves to be hard to realize, income is under intense pressure and the cost of doing business continues to increase. Probably the most powerful force to shape the retail banking industry is customer expectations, which are constantly increasing and demanding the banks to create and exploit knowledge in order to reach the customers' needs.

The structure of the paper is as follows. In the next section we focus on exploring the

innovation landscape in the banking system, along with the importance of risk management in the current post-crisis environment of the banking sector, while approaching the inevitable rush for financial performance addressing innovation goals, in a risk-averse culture. Evidence on the recent trend in the Romanian banking system, as well as earlier research on the topic of innovation in banks are presented. Furthermore, the second part of the paper presents our research design and the hypothesis set up, based on practical insights gained from the middle managers in banks. Finally, the results of our explorative study are discussed, including the implications for theory and practice, and further possible research directions are outlined.

This paper explains the identification of three hypotheses based on the literatures on risk management and innovation management in banking, and presents a preliminary analysis of the results of conducting an exploratory research based on input from risk management practitioners and innovation managers in Romanian banks.

2 Theoretical framing

2.1 Innovation pressure in banking

The evolution of the banking system is oriented towards the meeting of the needs of an environment where the competition is deepening and the exigencies of domestic and international regulatory bodies strengthens (Bucur, 2012). This also created a platform where the effects of the financial crisis flourished, in a system governed by hunger for quantitative targets, more clients, profit, resulting in an impersonal banking system.

Banks' business mix is changing significantly as a result of the fallout from the financial crisis, of the deteriorating macroeconomic environment as well as a response to the incoming regulatory reform. (EBA Report on Risks and Vulnerabilities of the European Banking System, 2012). A current trend is that most banks are consolidating their business, refocusing on their traditional "core" activities, which may be defined as simpler, lower-risk

and domestic business. By contrast, banks are exiting from their non-core business that they have been involved in and accumulated in the past in run-off or selling it to buyers who are either outside the EU or to the shadow banking system (EBA Report on Risks and Vulnerabilities of the European Banking System, 2012).

Accenture's analysis of more than 500 traditional full-service banks that comprise more than 85% of USA today's market came to this conclusion: banks need to move quickly to match the agility and innovation potential of the sector's rising new leaders, some of which bear little resemblance to today's institutions. Technology is a critical driver of the continuous innovation of digital products and services that will separate the high performers from the pack in 2020 and beyond (Accenture, 2014). The integration of new technologies, and the strategies, products and services they have the potential to engender, will be critical to banking success (Moreno, Pichler and Starrs, 2014).

Advances in technology such as digitization, as well as shifting consumer behaviours and expectations, are fundamentally disrupting the integrated banking value chain, creating numerous opportunities for innovation and new revenue streams (Moreno, Pichler and Starrs, 2014).

Inside the banks' structures, there is one internal driver for innovation that develops new premises for performance. Intrapreneurship, also known as corporate entrepreneurship is the practice of developing a new venture within an existing organization, to exploit a new opportunity and create economic value (Pinchot, 1985). In banks, by adapting intrapreneurship, a new and different corporate culture can be born, with employees channelling the company's resources in the purpose of creating better products and services. In this framework, risk knowledge sharing can be considered as a prerequisite of intrapreneurship (Coras. E, 2014).

Overall, the banks are often thought of as weak on innovation. But rapidly changing customers' needs, the development of technology, the pressure of the competition and the binding

regulatory constraints force banks look for new sources of competitive advantage, shifting their focus towards innovation.

2.2 Innovation and risk management in the banking sector

Fernandes and Paunov (2012) studied the link between innovation and firm survival by focusing on the role of risk as a crucial determinant of that link, while testing that a positive innovation-survival link is valid only for cautious innovators who are less exposed to risk. They referred to three dimensions of risks: the first relates to the lack of diversified sources of revenue resulting from new products or services, the second relates to the multiple technical challenges that need to be overcome by innovators in order to produce a substantially novel product that is better than the available products at a competitive cost, the third relates to the market challenges faced by innovators, the market conditions and sales strategies required to get the new product to be successfully sold in the market (Fernandes and Paunov, 2012).

Innovation has a large array of risks that affect the firm performance. A recent Harvard Business Review article addresses critical elements of innovation risk by offering five basic rules for managing them. The first rule is to recognize that a model exists and needs to be developed for judging risk and return. The second rule is that every innovation model has its own set of limitations. The third rule refers to the unknowns' possible occurrence. Even with unconstrained time and resources, an innovation model will never incorporate all the factors that could potentially affect the innovation's success and completely minimize its related risk. Risk managers should recognize that the process of identifying risk factors may incorporate going outside the scope of an innovations-related risk by considering how different conditions can affect a project's success. The fourth rule stresses the need to obtain intimate knowledge and understanding of the user. The final rule addresses the infrastructure the innovation will be placed in.

Businesses must look ahead to consider if the innovation they are pursuing to market will have an adequate infrastructure that will enhance the user's application of the product. Also, if the company identifies the need to change the current infrastructure, managers must dedicate a substantial amount of time to considering how long the change will remain viable (Merton, 2013).

In order to point out the immense focus of banks on the risk dimension, Pakravan (2011) highlights several key functionalities of the risk management inside the financial system: Risk management should be at the core of financial decision-making and capital allocation, market and credit risks should be priced accurately and reflect both micro-financial and systemic risks, the system should be transparent, which would allow the efficient functioning of market mechanisms and a more accurate and open risk-assessment system (Pakravan, 2011).

Innovation can be a company's most powerful tool and a key driver of value. Yet many executives, fearful of the risks inherent in pursuing edgy new ideas that may not succeed, prefer to renovate rather than to innovate. They argue that responsible risk management necessitates a cautious approach to innovation (Moreno, Pichler and Starrs, 2014).

The literature in the field of banking highlights directions for the development of risk management and bank performance in recent years focusing on banking risk management in crisis conditions. In addition, the importance and complexity of banking risk management, the rapid development of methods and techniques of management and, not least, the emergence of new types of banking services and products that have exposed the credit institutions and cooperative banks in particular the growing risks diverse and complex, requiring an update of the topic, taking into account the specifics of the banking sector in Romania and the reform in this sector (Constantinescu et al., 2014).

An integrated approach to risk management has thus become an important component of innovation in the face of the various risks throughout the innovation process.

3 Research model and hypothesis

Because an integrated approach to risk management involves many different aspects of an organization including its operations, marketing, capital structure and external partners (Stroh, 2005 and Lam, 2008), a firm adopting an integrated approach tends to draw on the skills and expertise it can command in a number of different areas in integrating a wide variety of different types of risks. It combines traditional risk management with financial risk management, but may also extend to management information systems, planning and line operations (Florice and Ibanescu, 2008) (Wu and Wu., 2013). In this study, we attempt to approach such an integrated innovation risk framework, by analyzing which factor are the most responsible for boosting the innovation potential of a financial company, while properly managing risks.

On the basis of the theoretical evidences, we identified three variables that might be expected to influence the extent of innovation in a financial institution, respectively a bank.

The following sub-sections introduce the bases of the hypotheses.

Intrapreneurship refers to "a person within a large corporation who takes direct responsibility for turning an idea into a profitable finished product through assertive risk-taking and innovation" (Pinchot, 1979). For Pinchot, intrapreneuring means a set of business practices that liberates people with entrepreneurial personalities to innovate rapidly inside larger organizations for the benefit of that organization and its customers.

Intrapreneuring becomes a distinctive component of companies with a solid innovation strategy, since the innovation potential is brought about by the entrepreneurial skills of the employees. (Coras, 2014).

H1: Creating an intrapreneurial environment inside the bank is positively correlated with the pillars of a sound innovation strategy.

Given the shortening lifecycles of products, the increasingly demanding customers, the competitors endeavours, the new strict regulations, the quantitative goals, banks are forced to rapidly react on the market. While successful innovation heavily thus relies on speed, it also requires an efficient risk management process that can recognize failures early and make adjustments in time. This process integrates risk management in the innovation cycle. Therefore, successful innovation is positively correlated to a rapid response to challenges in the banking industry.

H2: A speedy response to new developments is positively correlated to increasing the innovation potential of a financial institution.

The major weakness in banks, that affects all processes with no exception, is low capitalization. This induces financial pressures and strong limitations on people performance development (internal knowledge development, investment in intangibles, training, continuous education, organizational learning, access to external sources of knowledge), technology (adaptation to new technologies on the market, acquisition of new IT systems that facilitate internal processes, development of risk management systems), resources (Coras, 2014). Moreover, a solid innovation culture seeks to enlarge the sources of new knowledge and goes outside the boundaries of the firm. Sharing of resources enhances firm's capability and flexibility of conducting its innovative projects and decreases costs and risks.

H3: Diversification of resources and opening the boundaries of a bank's structure is positively associated with an effective innovation strategy.

4 Research methodology and analysis

The current research applied on the Romanian banking sector uses a structured, open-ended, interview approach to capture the information.

The major weaknesses of the Romanian banking sector, namely the significant level of

non-performing loans – in the context of the negative dynamics of lending to the private sector – and the faster cross-border deleveraging, are currently manageable. The main challenges to financial stability over the period ahead are posed, the same as in most EU economies, by the sustainable resumption of lending, against the background of ongoing and even faster deleveraging internationally, and the adequate management of bank asset quality, also by striking a functional balance between the costs and benefits of various alternatives in addressing non-performing exposures (NBR, 2013). NBR recommends that in order to consolidate a stable economic environment, innovation should play a more prominent role in economic development (NBR, 2013).

Data were collected through semi-structured interviews with fifteen middle managers from three large banks in Romania. This technique is regarded as appropriate when little is known about the subject in hand (Maykut and Morehouse, 1994), thus it is suitable when the topic comprises an exploratory element (Saunders et al., 2007). The interviews were conducted having as foundation a questionnaire. The questions included detailed information concerning banks investment in different types of innovation, their financial constraints, their access to diversified resources, their technology implementation and other relevant information that can be used to investigate the extent of involvement in innovative activities and the efforts allocated to risk mitigation in developing new product, services or processes.

Finally, all three predictions were rated on the same Likert scale, 1 strongly disagree, 2 disagree, 3 neutral, 4 agree and 5 strongly agree. We consider highly relevant for this research the opinions of middle managers in banks, since they have access to key information, foster communication about the organization's objectives, interact with a diversity of stakeholders and encourage rational risk taking. Middle managers stimulate corporate entrepreneurship (Hornsby, Kuratko and Zahra (2002) and therefore they need to be connected to all structures in the system.

All three hypothesis were validated by our exploratory research. Intrapreneurship was found by all bank experts fostering the corporate culture focused on innovation, proving that the highest the investment in people resources, the highest the capacity of building an innovation strategy.

5 Conclusions

What is encouraging to see is that there is now a large-scale focused innovation effort by the banks that is apparently aimed at averting an inexorably tragic end (Denning, 2014).

Banks need innovation as a prerequisite for a long-term development. Now more than ever, we need modern technique to stimulate creative thinking and also adequate environments in order to lead to innovation. Firstly, the necessity of innovation in financial markets was measured by the utility test of Internet Banking. Long-term, the convincing and competitive advantage is represented by knowledge and competence management, followed subsequently by skilled employees. Within every filed (tech, design, marketing, managements), innovation requires creativity, knowledge and communication skills. In order to have qualified workers, companies must set the investment in consulting as a high priority element and the education as a constant process (Suciu and Florea, 2014).

The banking sector is characterized by a low innovation capacity and a highly risk adversity. Through our research we have tried to blend the classical risk management framework operated in banks with their strive to innovate, defining the pillar for a new model of innovation risk management – intrapreneurship, technology and resources.

Three hypotheses were tested, in order to relate risk management concepts and innovation culture concepts. We have obtained key responses from 155 field risk and innovation managers. All hypotheses were supported by their feedback.

The limitations of this study also refer to the exploratory method used to reach consensus on the proposed hypothesis, and the lack of an

extensive quantitative study, measuring the validity of the variables proposed. Other variables may be proposed and further quantitative analysis should be conducted in order to fundament the robustness of the innovation risk management model.

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Author description

Eliza Coras. Her field of work is credit risk management but during her ten year experience in the banking industry she has accumulated extensive knowledge on all banking processes and risks. She is currently advancing her business risk knowledge and intrapreneuring experience by attending a PhD programme at the Bucharest University of Economic Studies. Her research is focused in risks in the innovation process and her practical studies are aimed to open innovation practices.

Horatiu Regneala. He is general manager at Renovatio Solar, a renewable energy company. He has a comprehensive knowledge in solar energy industry. He is currently enrolled in a PhD programme in business administration at the Bucharest University of Economic Studies. His research is focused on strategic management in the renewable energy industry.