

Innovating in finance innovation: banks double up on the digital revolution

Innovation has long been key to any analysis of how economic growth works, ever since the work of economist Joseph Schumpeter. Schumpeter defined innovation to include not only new products but also new procedures and new forms of organisation. Innovation clusters cause ruptures that challenge existing models and force firms to reinvent new and higher value-added models. The Austrian economist goes on to describe how this discontinuous and spontaneous process drives the transformation of capitalism and puts one figure at the heart of the process: the entrepreneur, who alone can turn innovation into a reality but who needs the support of sound and stable monetary institutions.

This thinking so perfectly mirrors the world of the digital revolution that it is easy to forget how long ago he was writing. In his work we find the burgeoning diversity of inventions, the shattering of modes of consumption, deep changes in the organisation of work, the creative destruction of capitalism on the move...and the key issue of finance through capital and/or credit.

What makes today's situation special is the breakneck pace at which innovation spreads, challenging our capacity to adapt, whether as individuals or as organisations. No business sector is unaffected by the digital shake-up, no company, large or small, and no market.

That said, the banking sector is special, due to the very nature of its business. Banks face a double challenge. They are digital players themselves and must also finance the digitisation of their customers. Not only must they rethink their own models - like other companies wrestling with technological revolution and an influx of new competition to already hyper-competitive globalised markets - but they must also find the right technical solutions for the new financing needs of other players in the market, their customers.

Here, they run into a contradiction between the need to fund innovation and the prudential treatment of intangible investments under EU directive CRD IV. The directive states that they should be treated as "non-valeurs" (assigned no value). This approach is both outmoded and deeply unhelpful to developing the digital economy, forcing firms, as it does, to deduct intangible assets from capital.

Clearly, then, we need to completely overhaul the accounting, regulatory and financial software if we are to effectively support this great drive for innovation, whether at its start-up, development or export phase.

Innovation has multiple dimensions and so too does its financing. Finance must be diverse, sometimes debt, sometimes capital, often a combination of the two. The question of financing innovation comes down to the financiers' evaluation of risk. Innovation is often accounted for as a cost (salaries, research studies, marketing expenses, etc.) in which it is hard to see the return on investment. What is more, by their very nature the things being financed cannot be posted as collateral.

There are a number of technical solutions, but nothing can replace knowing your customer and understanding their projects. Innovation finance is often tailor-made.

Bank networks, which have long historic ties to their customers and the local environment, know how best to support them, whether by loans, by raising fresh capital which often means finding the right investors (crowdfunding, investment fund, etc.), or by tapping the markets. The strength of the French universal banking model is that it can offer firms the right financing mix for their circumstances.

The model has proved its efficiency at financing the economy over the last decade. Figures show French banks to be the best in Europe when it comes to financing firms, with a €948 bn loan book at end-July 2017 (up by 5.1% year-on-year). Despite what is often said, they have proved well able to adapt to the needs of the new economy, particularly those of young and innovative companies with high growth potential.

Banks are the natural leaders of the French digital finance sector. They have created a dedicated ecosystem for start-ups. This includes innovation-focused business centres, specific credit products for innovative companies and ever-better training for customer relationship managers dealing with these new issues. Most banks have well-funded support networks and specialist divisions to promote relations with SMEs, mid-sized firms and start-ups. They have invested massively in incubators, where start-ups can find support and pool experience.

However, the current effort by banks, held back as they are by the treatment of investment in intangible innovation and constrained in their lending by prudential requirements, will not be enough. The upcoming generation of entrepreneurs needs a new generation of investors, outside the interventions of banks and public assistance. The government must find a way to persuade French people to invest their savings in innovative companies. This will require education and some strong and stable tax incentives.

France has every possibility of becoming a land of innovation. It has the engineers, the ideas and the bank-based financing system which the OECD has classed as one of the key assets of the French economy. We are also seeing a resurgence in the confidence without which there can be no risk-taking culture and no innovation.

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