



INNOVATION-BASED SUSTAINABILITY AT CAPITAL ONE FINANCIAL

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“Capital One is an innovation laboratory where entrepreneurs start micro-businesses and test ideas that add value for consumers.”—Capital One Financial Annual Report 2000

About the Author:

Johanna Woll is a senior consultant at the Cap Gemini Ernst & Young Center for Business Innovation. Johanna has led the research for and managed the publication of the third book co-written by Christopher Meyer and Stan Davis. This book lays out some of the technologies and principles of a post-information economy driven by advances in the molecular sciences. Over the past year, she has been exploring recent developments in biotechnology, nanotechnology, and materials science through executive interviews and secondary research.

With 43.8 million customers (and membership growing at a rate of more than 430 percent for the past three years), \$45.3 billion in managed loans, and earnings of \$642 million in 2001 (a 30 percent growth rate), it's no wonder Capital One Financial is considered one of today's most innovative companies. Innovation at Capital One Financial cannot be traced to a single department or set of activities. It's not a unique R&D function; there is no internal think tank. Innovation is not localized but systemic. It's the lifeblood of this organization and drives its remarkable growth.

How does the company establish and sustain a track record of such growth and innovation? The short answer would cite an information-based strategy and exceptional people. But these are merely the resources. Applying these boldly—but judiciously—generates the remarkable results. Two characteristics, in particular, drive every one of Capital One's serial innovations: a process of testing and launching information-based offers rapidly and frequently and an unstructured, bottom-up corporate environment.

Feeding Innovation

Information-Based Strategy

In today's global, connected economy, companies have unprecedented access to information—information on customers, on channels, and on costs. Fierce competition has forced down the price of communications technology and has driven an explosion in the capacity to capture and manipulate information. Though information is proliferating at an incredible

rate, many companies fail to tap into this prodigious source of value.

Capital One is built on it. Information-Based Strategy (IBS), Capital One's proprietary approach to managing data, describes not only the raw material, but its artful analysis. Capital One uses information to design massively diverse, multidimensional models of potential offers. A strategy of modifying a core offer along selected dimensions—such as product, price, promotion, or channel—spawns infinite diversity, and from this diversity emerge winning innovations. Last year, Capital One conducted 64,000 structured tests. A highly developed competency in test design allows them to test very hostile—that is, negatively profitable—areas of the market, areas that their competitors often avoid. This kind of testing allows Capital One the opportunity to find profit in the riskier markets—ones that would typically be avoided.

Capital One adds continuously to this data source, actively gathering information about its customers and the marketplace. For example, by monitoring traffic at its website, it can determine which visitors become customers. Based on this information, it's able to create banner ads to match the demographics and affinities of eyeballs at other sites.

Capital One's Lifestyles product set serves thousands of micro-segmented niches in the marketplace. Lifestyles credit cards feature pictures that match customers' interests—Japanese gardens, Latino culture, and so on. Snowboarding enthusiasts might

have cards that show a snowboarder jumping off a mogul, and their monthly statements might include inserts that describe tournaments, broadcast updates, or special promotions.

This product line is driven by consumers' "pockets of passion." Since Capital One cannot identify and analyze these scientifically, it conducts detailed market research and creates numerous micro-affinity categories themselves. Without any partners (and no commissions), there's a huge amount of risk involved. Capital One creates these mass-customized credit cards by focusing on the confluence between people's emotional connections and their needs. Then, it offers a whole series of account management programs—interest reductions, interest increases, line extensions, line depressions—built on data it gathers about customers' behaviors.

People

Any company's success begins with its people. While most companies know this implicitly, Capital One pursues it explicitly, in its recruiting, hiring, assimilation, and performance processes. Growing a company from 2,000 employees to 20,000 employees in seven years calls for an extraordinary commitment of resources.

Indeed, senior executives at Capital One spend up to 25 percent of their time recruiting . . . which is better, they say, than spending double that amount later managing mistakes. They look for entrepreneurial, analytical, ambitious, and self-motivated people.

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People who are passionate enough to pursue an idea that they believe in, even if doing so means extending well beyond their primary responsibilities. In fact, responsibilities are somewhat undefined, by design.

New hires won’t arrive at Capital One and find a policy book. Instead, they are put through fairly elaborate assimilation programs during which they are told about the Capital One business strategy, the business model, and the organization. Then, they are given a Success Profile that outlines the behaviors that make for an effective employee. The Success Profile outlines 23 competencies, clustered around five primary success factors, behaviors like building relationships and taking personal ownership. These detailed behavioral descriptions form a clear and practical road map for career development.

Innovation in Practice

Product Churn and Testing

“When you work backwards from the marketplace, there’s a life span of six months for any product, so you have to create a completely different kind of financial services company, and it’s based on innovation.”—Rich Fairbank, CEO

At Capital One, short product life cycles are both the impetus and consequence of innovation. Sixty percent of its products didn’t exist six months ago; 80 percent didn’t exist one year ago. With products that are entirely intangible and very flexible, innovations can hatch like fruit flies or bacteria, and Capital One can respond quickly to a capricious consumer market to capture first-mover advantage.

Product churn creates more opportunities for migrating to new market niches before the competition, and a diversity of offers and the ability to generate new offers quickly improves robustness in a rapidly changing environment. Capital One produced 6,000 new offers last year, each one a response to a new opportunity identified, or at least sensed, through market tests. When the raw material is information, failure is relatively cheap but extremely valuable in what it can teach. If you kill an idea in the lab, you can’t learn. So, Capital One lets the market test new products. Here’s how it works.

A project leader, often self-appointed, recruits a cross-functional team to pursue an idea. Once a loose team is assembled, it explores the idea in a brainstorming session, tapping the group’s intuition, listening to diverse perspectives, and presenting findings derived from initial research. The team then identifies a range of customer segments for test marketing (based on demographics, lifestyle, life stage, credit risk, and so on), builds a model, launches a beta test, and screens the results to select offers with the highest profit potential. If an offer passes the tests, it is rolled out to the entire target group. Later, Capital One might decide to exit the offer (even if only temporarily). Impermanence is a fact of life.

Information gained during this entire process helps refine the model. It might lead the team to think differently about credit policy or to generate new hypotheses that could point to alternative, even more profitable offers. The strategy emphasizes diversity;

it's all about creating seeds for future success, even if in the short term they do not prove profitable.

Each test is deliberately designed to test extremes, up and down the risk spectrum. More often than not, the insights that drive Capital One's product innovation, which expand its competitive advantage, come from the fringe.

Most companies conduct market research, design products, roll them out, and then live with their success or failure. In contrast, Capital One looks for promising economic levers, and using a variety of quantitative and qualitative market research tools, engages with customers to understand their needs. The modelers combine these factors and build them into the test designs. By launching tests in the marketplace and analyzing the feedback, Capital One can figure out not what customers say they will buy, but what they actually do buy—and that's what it rolls out.

This kind of test-and-learn culture requires the scientific disciplines of rigorous testing, experimentation, and analysis. This kind of discipline shows up in decision-making, too. Without smoking-gun evidence that the economics are as positive as they were in the test, a project cannot go forward. At Capital One, employees can't actually harvest the values out of the testing program unless someone more senior studies the test results, agrees to the analysis, and authorizes, in most cases, a quantum shift in the marketing budget, earmarked to chase the opportunity.

When Capital One wanted to establish a process for accepting credit card applications electronically, it was able to build on the credit policies and fraud technology it had developed for other products. Capital One was one of the first in the industry to process applications online, and it now serves more than 3 million customers through this Internet channel. Initially, it encountered massive fraud, so it kept its activity volume at a low testing level, for more than two years, before scaling up. The company continued to get reads on the performance of the accounts originating on the Web and acted on this feedback to build better fraud defenses, learning how to detect and reject computer-submitted applications (for example, those filled out in less than a millisecond or those submitted using the same computer ID number or ISP session number).

Rather than conducting thousands of fraud prevention tests in the lab, Capital One let the market teach it how to deal with fraud. When it encountered new problems, it scaled back the project and returned to testing until discovering a solution. This test-and-learn cycle permeates every activity at Capital One, and underlying it is a commitment to acting on feedback, to analyzing information every way possible, and to using it to make smarter, more intelligent, or profitable business decisions. In doing so, it empowers the organization to grow very rapidly with very high profitability and to out-manuever competitors. The information flow is so close to real time that it can turn on a dime and react. In the case of fraud

Innovation is not a process at Capital One. Rather, it is the underlying philosophy upon which every aspect of the company is organized and managed. Information is the company's sustenance, and it uses market data to constantly bring new credit card offers to consumers. Capital One learns by designing models of its potential offers and by listening to feedback gleaned from experimentation in the market. Combining this information with an emphasis on an entrepreneurial spirit among its employees, Capital One has created the most innovative corporate environment in its industry.

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detection, a rapid feedback loop lets the company know within a single day that it has a problem. Without these kinds of information systems in place, it might not learn about fraud for months, perhaps, or until the quarter closes.

Capital One has even translated this testing culture into its hiring process. Candidates must pass a series of tests, designed to uncover their analytical and behavioral strengths and weaknesses. The same kind of modeling correlates post-hire performance with pre-hire test results and identifies potential performers very early on.

A Fluid, Forgiving Culture That Encourages Risk

"At Capital One we create an environment where scientific labs can be created, where people can fly, where exploration and risk-taking are rewarded and failure accepted."—Rich Fairbank, CEO

At Capital One at any one time, there are hundreds of in-house entrepreneurs running internal businesses. These might be activities, product lines, or entire units with their own P & L's, but each is run as an individual business. There are hundreds of such enterprises running inside the company, and the profits generated and claimed by them add up, at least virtually, to several times corporate earnings.

In such a fluid environment, ideas percolate from the bottom up. Indeed, Capital One's corporate culture evolved from the founders' understanding that the command-and-control strategy typical of most lending institutions severely curbs the potential for innova-

tion and rapid growth. In Capital One's less hierarchical environment, local information can drive decisions. Associates, who are closest to the data, are empowered to find better ways of operating, put a business case together, and make it their mission for that quarter. Such direct feedback keeps pressure on the entire system to improve continuously.

In many ways, Capital One is a chaotic culture, where people just bump into each other somewhat randomly, like molecules in Brownian motion. When one person bumps into another who's headed in a similar direction to pursue a similar idea, the two negotiate to determine who should continue on. Often they make commitments to each other and maintain contact in a customer and performer relationship. Such random encounters serve not only to eliminate redundant efforts, they enable innovation by bringing diverse elements together. Without these kinds of connections, diversity has little inherent value. Introducing new people into such a culture can be a struggle. Without a formal work chart, and few clearly defined roles, it can be a very intimidating place for new people, and it takes them a while to understand where they can add value and what is expected of them.

But the benefit of loosely defined responsibilities is that no one knows where his job ends and someone else's begins. As a result, people will go to great lengths to make sure that they optimize whatever it is that they're working on, whether a particular product, mission, channel, or process. Managers really are like coaches, encouraging their staff to

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step off the cliff and just jump into the organization, trying to create change and trying to identify value-creation opportunities.

Capital One’s associates have permission to fail; there are no negative repercussions for trying something that didn’t work, as long as they behave according to the rules. Rather than penalizing people who fail, Capital One’s leadership praises them for their commitment and intentions. CEO Rich Fairbank often asks them to explain what happened, so that others can learn. In doing so, not only does he reinforce the organization’s tolerance of risk and failure, he sets expectations and helps revise best practices. Capital One separates outcome from behavior and balances these factors when evaluating performance.

Last year, an associate in the collections department was working her way toward a big award for conducting 10 perfect calls. After nine successful calls—monitored by her boss—she broke rank and risked it all, violating company policy for the sake of a customer in need. She gave the customer \$700, a huge amount relative to the credit line. She explained to her superiors that treating customers with compassion was not only more effective in extracting payments, it was highly effective in building trust and loyalty.

In the end, her boss was really pleased that she had uncovered a poor policy. Rather than punishing her, he celebrated her insight and boldness and communicated several important messages. He reconfirmed

that it’s okay to break the rules in the right way. And he acknowledged that, at Capital One, it’s the keen, hardworking associates who are the real heroes, the ones that the company depends on.

Capital One has shaped its organization by developing a competency model that integrates hiring, performance management, professional development, and pay—a compensation program favoring long-term incentives, such as stock equity-based compensation, that really promotes value creation. Performance reviews with 360-degree feedback happen twice a year. And while many companies focus their performance process on competencies and results, Capital One evaluates, in addition to these, performance potential and people’s ability to learn and grow quickly.

Testing, failing and learning, shifting, and recombining . . . innovation at Capital One would be far less successful if these guiding principles did not permeate all aspects of the enterprise, from offer and technologies, to employees and new business ventures. Together, they enable the organization to grow, improve, and innovate, to respond to change with change, and to thrive in a volatile economy.