Success Tomorrow Depends on Business Model Decisions Today

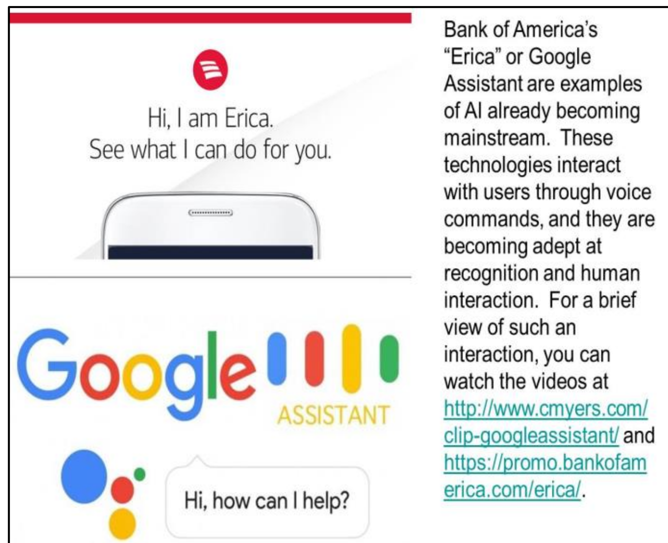
Imagine it is 2025 and Artificial Intelligence (AI) is mainstream and pervasive in our lives. How might AI impact the financial services industry? What are the potential opportunities and risks?

Consider, what might people ask of their AI assistant?

- Move all but $5,000 from my savings account to an insured money market account at the institution that pays the highest rate
- Find the lowest auto loan rate and refinance my auto – I want to pay it off in 3 years
- Analyze my CD portfolio and, if there's an opportunity to earn more interest in another CD after paying the penalty, please proceed with the transaction
- Find me a 0% interest rate credit card promotion, and set a reminder to transfer the balance to another card prior to the expiration of the promotion

AI *may* or *may not* be the next big influence. The point is that competition is increasing and technology is getting smarter, giving consumers more options.

What could the financial institution do to be ready for this future? How might this future be turned to their benefit? What technology, products, services, or talent would need to change?



Bank of America's "Erica" or Google Assistant are examples of AI already becoming mainstream. These technologies interact with users through voice commands, and they are becoming adept at recognition and human interaction. For a brief view of such an interaction, you can watch the videos at http://www.cmyers.com/clip-googleassistant/ and https://promo.bankofamerica.com/erica/.

AI may or may not be the next big influence. The point is that competition is increasing and technology is getting smarter, giving consumers more options. Even if AI is not the world you foresee, leaders today need to think about what future is anticipated. Beginning to build the right business model today will allow you to arrive at that future with what you need to be successful.

Successful businesses will need to understand and deliver on the optimal business model of the future. Financial institutions will have to clearly articulate the products, services, and experience they will be exceptional at, as well as what will not be their focus.

Optimizing the business model allows maximum focus and maximum utilization of the financial institution's limited resources.

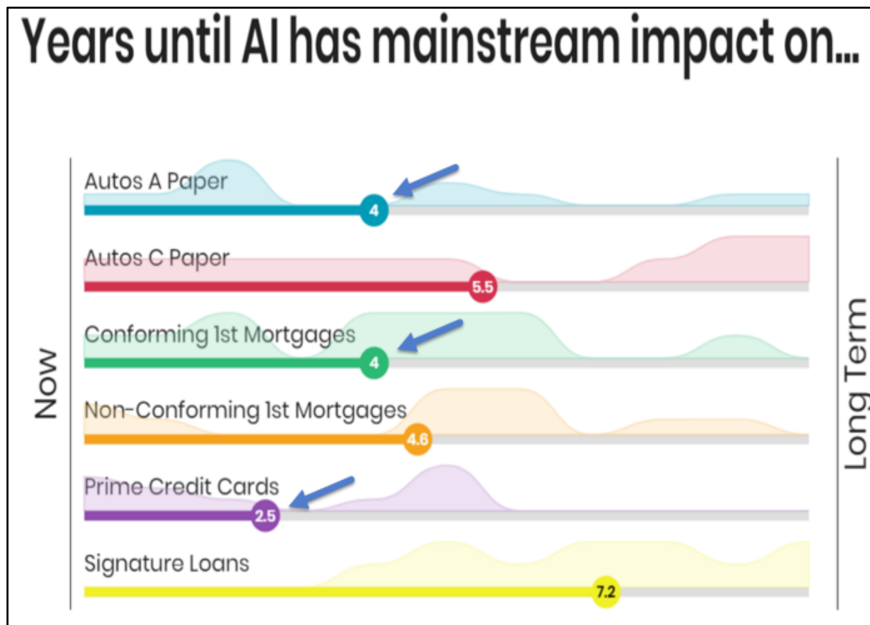
So what does building the optimal business model look like? What are key considerations? What questions should be asked?

Of course, to begin with, leaders need to identify and gain consensus around the most likely future environment. That may seem daunting. However, in times of fast-paced change, companies need to be continuously scanning their environment for new risks and potential opportunities. Leadership teams can bring multiple perspectives and valuable discussions to enlighten a path. The path will be uncertain, but taking aim in some expected direction is preferable to not taking aim at all.

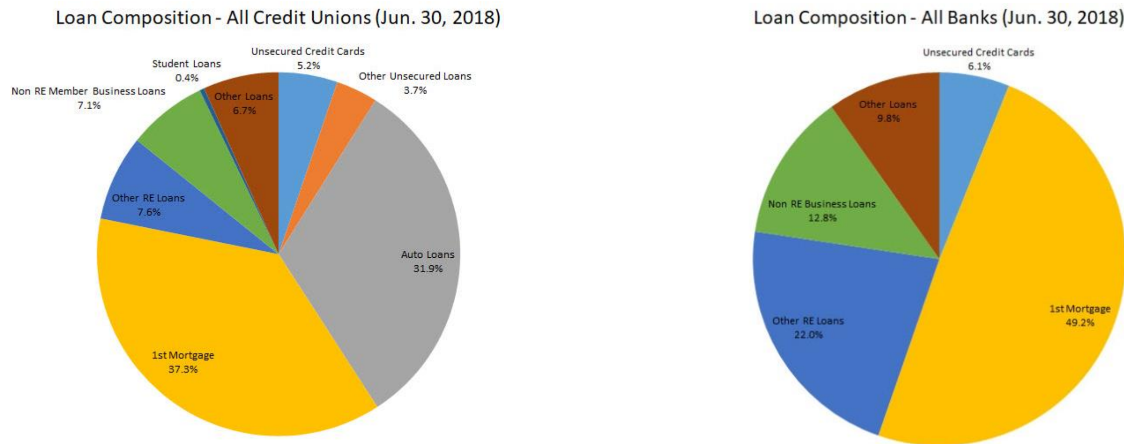
Opportunities Ahead!

One approach to assessing the risks and opportunities in the future would be to survey the key stakeholders and influencers, and collect their impressions.

In the example survey below, key stakeholders have been surveyed about AI impacts on loan products and provided their estimations. Notice that the team anticipates Autos A Paper, Conforming 1st Mortgages, and Prime Credit Cards to be impacted within 4 years or less. Notice, too, that a common thread for the more near-term impact is that the products tend to be more straightforward and repeatable, while the longer-term expectations relate to loans that are more customized and complex.



If the stakeholders' premise were to become true, what might the impact look like? For the credit union industry as of June 30, 2018, auto loans (31.9%), 1st mortgages (37.3%), and unsecured credit cards (5.2%) make up roughly 74% of total loans. Bank data, though broken out a little differently, shows that 1st mortgages and unsecured credit cards make up about 55% of total loans. A financial institution could perform a similar analysis of its own loan composition.



Source: Callahan & Associates, Inc.

With the survey and the percentages of loans that could be impacted, the key stakeholders may conclude that a significant competitive impact is coming for the industry and begin to consider its unique business model strategy in response. Linking potential futures with real world data can create meaningful business intelligence, better enabling leaders to identify and test alternative strategies.

Once an anticipated future is identified, the good news is the remaining process can be more straightforward. As discussed below, it includes revisiting the business fundamentals underlying the financial institution in light of the expected changes in technology, competition, talent, etc.

Revisiting 4 Primary Business Questions

Every business needs to circle back and make sure these 4 primary business questions are front and center of decision-making. These business model questions help to answer: *Is our business model positioned to keep us relevant for the foreseeable future?*

When contemplating this process, recognize that while thinking through the answers is important, equally critical is the common understanding developed through healthy discussion and debate. High functioning teams will engage in open dialogue with productive pushback, thereby crystalizing the reasons for why the strategy was selected and why others were not. The goal is strategic clarity. Strategies may not require change, but decision-makers should reaffirm strategies to remain relevant or adjust them as necessary for a changing world.

1 Why do we exist?

Every business exists for the benefit of its consumers. Answering this question more deeply and precisely can lead to clarity that helps the whole organization better deliver on its purpose. This is particularly important as things become more complex and ambiguous, and the financial services industry becomes more commoditized.

Take for example these purpose statements:

"We ignite opportunity by setting the world in motion."

"To be Earth's most customer-centric company, where customers can find and discover anything they might want to buy online, and endeavors to offer its customers the lowest possible prices."

"To build the Web's most convenient, secure, cost-effective payment solution."

"We save people money so they can live better."

2 Who should be in our target market?

Who should the target markets include for the financial institution? The community in which you operate is not a target market, and for credit unions the field of membership is not a target market. While demographics may play a role, considering consumer behaviors, lifestyles, and credit status is not optional in identifying target markets. For example, not all 50-somethings making $100,000 per year have the same preferences, behaviors, and life needs.

Having clearly defined target markets acts as a filter to help businesses strategically allocate limited resources. With the target markets in mind, a financial institution will design delivery channels, products, and services based on its target markets' needs and desires, and not try to be all things to all people.

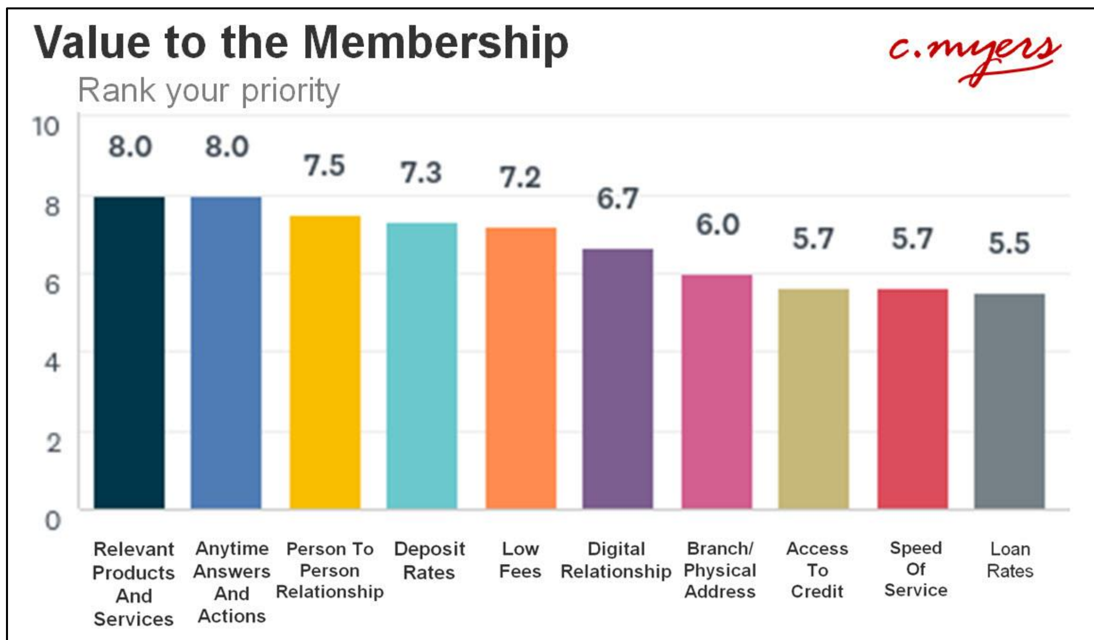
3 *What should our value proposition be?*

A value proposition helps to solidify in decision-makers' minds why their target markets would choose to do business with them versus the numerous other choices they have.

If the value proposition is not clear to the decision-makers, then it won't be clear to their target markets, which means great opportunity will be lost.

A value proposition is what a consumer may say to a neighbor, co-worker, or family member:
You should do business with this financial institution because this is what they did for me…
It helps all employees understand what the business must be great at every day.

Revisiting this question can mean understanding the value propositions that are most important today, as well as looking ahead to the future, and considering what value propositions may become more important in 5 or 10 years. Consider a survey which identifies key member values and asks participants to rank them for today and into the future: The example survey below provides the values that are the highest priority today.



4 *How will the business develop and utilize its core strengths?*

A core strength is something unique about a business's structure and operations that creates a competitive advantage in delivering on the value proposition to its target markets. It can differentiate the financial institution in the minds of the target markets.

Consider exercises like the following for your board or management team. As part of the exercise, require a minimum number of answers for each box.

What will the CU be…

Great at	Good at	Not Good at	Not Do

You can apply these characteristics as a filter for loan products, deposit products, etc.

Sometimes simple visuals result in extremely productive discussions. This visualization can be applied at the organizational level down to the product level.

Every business has a business model but not all are understood. When the business model is clearly defined, a financial institution can effectively use it to guide decisions on products, services, and delivery channels. It also helps identify gaps between where the institution is and where it wants to be, which can help determine where progress needs to be made.

Business model strategies can be assessed from a variety of perspectives. Does the business model compete on rate or does it compete on high-touch service? Are the target markets broad or more niche focused? Regardless of the choice, leaders need to build the model to deliver effective and sustainable earnings.

Consider the assessment of a business model designed to deliver highly scalable products and services versus one organized around being highly customized and high-touch.

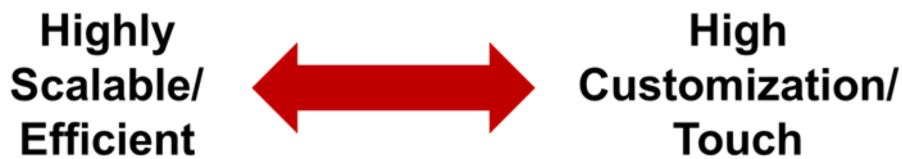
Highly Scalable vs. Highly Customized

In the previous survey to identify future opportunities and risks, respondents noted that AI was more likely to occur sooner for some loan products and not others. AI becoming mainstream was thought to be quicker for products like A paper autos, conforming mortgages, and prime credit cards. These products are fairly straightforward; documentation is standard and

underwriting decisions are largely rules-based. These products lend themselves to being highly scalable and delivered through efficient processes.

Conversely, there's more complexity, nuance, and gray area when gathering data and approving lower credit consumer loans or non-conforming mortgages. These require more interacting with customers, weighing mitigating risks, and sometimes thinking outside the box or using experience and intuition. These products require more human touch and/or higher customization, which can make them less scalable.

Assessing scalability versus customization is not black and white, though they are often considered to exist on opposite ends of a spectrum.



Computers have been effective at high volumes of data and performing repetitive, clearly defined logical rules. It's worth acknowledging that increased computing power and new algorithms are poised to enable AI to move beyond traditional computing, and into the more complex "thinking" once limited to humans – making mass customization a distinct reality and more affordable for many businesses. Until this future becomes a reality, technology and process efficiencies are likely to play a larger role sooner in the highly scalable arena, taking advantage of the low hanging fruit.

Comparing Business Model Strategies

Due to automation and efficient processes, over time a highly scalable business model strategy will typically compete on rate. Because they compete on rate, financial institutions employing an effective highly scalable strategy endeavor to minimize the required operating expenses.

> *The first rule of any technology used in a business is that automation applied to an efficient operation will magnify the efficiency. The second is that automation applied to an inefficient operation will magnify the inefficiency.*
>
> **—BILL GATES**
> FOUNDER, MICROSOFT CORP

Conversely, the effort required to deliver a more highly customized or human touch product typically entails more costs, and therefore often does not compete primarily on rate.

Business model strategies at either end of the scalable/customized spectrum can be equally profitable. However, the business model surrounding them will be designed very differently. Let's take a look at how similar profitability can be achieved, albeit through very different means.

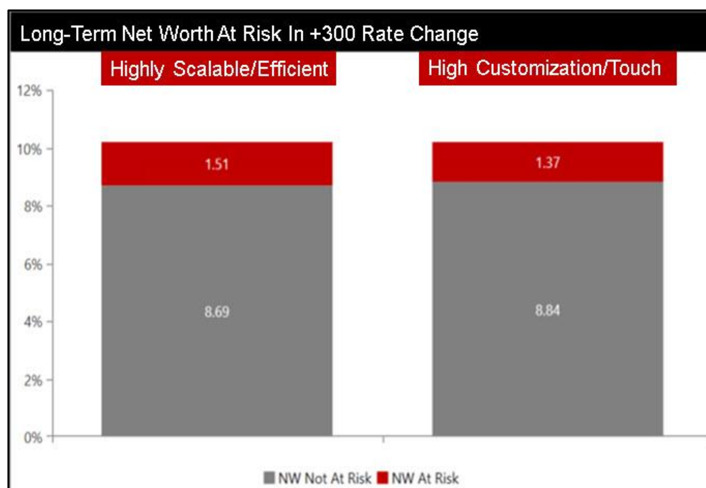
Notice the bottom line profitability of both strategies is a resulting 1% ROA. However, the Highly Scalable/Efficient product strategy competing more on loan rates drives a materially lower Yield on Assets than the High Customization/Touch product strategy (2.55% vs. 4.59%).

With a similar cost of funds, the result is a margin difference of 2% between the two models. For the Highly Scalable/Efficient business model to be equally successful it has to utilize efficiencies to achieve lower operating costs – in this case an operating expense ratio of 1.75% or less. Differences in credit characteristics, as well as non-interest income opportunities, are equally important to the success of each strategy.

	Components of Earnings	Highly Scalable/Efficient	High Customization/Touch
1	Yield On Assets	2.55%	4.59%
2	Cost Of Funds	0.67%	0.62%
	Margin	**1.87%**	**3.97%**
3	Operating Expense	2.00%	3.75%
4	PLL	0.27%	1.03%
5	Non-Interest Income	1.40%	1.81%
	NOE	**0.87%**	**2.97%**
	ROA	**1.00%**	**1.00%**
	Loan to Asset Ratio	73%	73%

Decision-makers will also want to understand how those structures would perform differently in changing rate environments. How does the long-term profitability hold up in different rate environments? What are the implications to short- and long-term net worth?

The good news is either strategy can also be effective in changing rate environments. If we model a changing rate scenario and measure earnings over 4 years, both business models experience their first negative average ROA when short- and long-term rates are at 5% (or in a +300 bp rate increase from today).

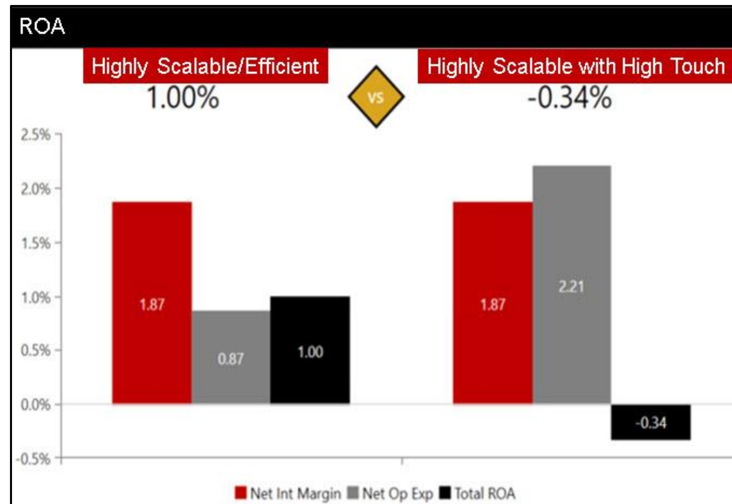


Carrying the impact of earnings in a +300 bp rate environment (i.e., short-term rates at 5%) forward to net worth, the results remain close. After 4 years, the Highly Scalable/Efficient business model has 1.51% of its net worth at risk, while the High Customization/Touch business model has 1.37% net worth at risk.

In fact, with equal starting ROAs, both business models can be effective through a +300 change in market rates. Although the sources of risk are different, the resulting interest rate risk is about the same.

Selecting Your Business Model Strategy

While either strategy can be effective, straddling both typically won't work over the long term. That is to say, competing on loan rates while having customized, human touch-type expenses would not support sustainable profitability. The impact of straddling would not be observed overnight, but would become evident over an extended period, increasing the importance of modeling the impacts over a horizon greater than 1-2 years.



Notice in the figure to the right that with the same net interest margin, the Highly Scalable/Efficient strategy becomes unprofitable when combined with the full operating expense structure (see the gray bar) of the High Customization/Touch model. The ROA moves from 1.00% to -0.34%.

When choosing a business model strategy, recognize that making a change is not a matter of flipping a switch. Various options should be analyzed and considered in light of the overall business model, and how that model will be positioned to best serve the membership into the future. If the decision is made to change strategies, a deliberate tactical plan for change will likely require living in transition and straddling strategies for an interim period. Decision-makers should understand this could mean additional pressure on earnings during the transition, and determine how long that pressure could be expected to go on.

Know the Numbers

Whether or not significant changes are made to the overall business model strategy, it's critical to play out the expectations financially. Every strategy must result in a sustainable business plan.

Understand the five strategy levers that determine bottom line ROA and how they could be expected to deliver long-term profitability:

1. **Yield on assets:** loan mix, yield on loans, loan-to-asset ratio, yield on investments, liquidity strategy, non-earning assets
2. **Cost of funds:** non-maturity mix and pricing strategy, CDs, borrowings, net worth
3. **Operating expenses:** technology, talent, facilities, third-party reliance, etc.
4. **Provision for loan loss:** credit strategy, impact of CECL
5. **Non-interest income:** fee strategies, interchange, loan sales and servicing, etc.

Projecting the business model strategy beyond 1 or 2 years is essential to proving out sustainability. Building a long-term forecast should also include identifying linchpin assumptions, and testing outcomes and sensitivities if those assumptions don't go as planned. This should include testing the strategy for a variety of potential market rate scenarios. Then, with a clearer understanding of financial outcomes, take the additional step of asking *"What if this plan comes true?"* If the strategic implementation goes as projected, does the resulting financial structure after 4 or 5 years result in an acceptable level of risk?

Aggregating Risk for Strategic Net Worth

Long-term earnings and net worth serve as the primary measures of financial health. Aggregating identifiable risks is a way to see how much net worth may be available for transitioning to the optimal business model, and whether there is enough net worth to support the business strategy. Does net worth provide safety for identifiable risks, while also providing strength to take advantage of strategic opportunities?

In this example, a credit union works through the exercise of determining their required strategic net worth. The analysis begins with identifying the current total net worth percentage, or 10.20% in this example.

Several key risks and opportunities are identified and quantified: interest rate risk (1.51%), credit risk beyond the existing loan allowance (0.66%), current expected credit loss (CECL) conversion (0.28%), merger strategy (0.35%), etc.

The sum of the risks and opportunities are deducted from total net worth, arriving at 6.95%.

Aggregating Risk For Strategic Net Worth

Assets ($000s)	NW $s	Total NW%
1,319,872	134,642	10.20%

Risk	NW%	% of NW at Risk
Interest Rate Risk	1.51%	14.80%
Credit Risk	0.66%	6.49%
CECL	0.28%	2.74%
Regulatory/Legislative Risk	0.15%	1.47%
Merger Strategy	0.35%	3.43%
Business Model Transformation	0.30%	2.94%
Total NW To Support Risk	**3.25%**	**31.88%**
Net Worth After Aggregate Risk	6.95%	
Minimum Net Worth Required	6.00%	
Net Worth Cushion	**0.95%**	

Through risk appetite discussions among decision-makers, this institution established a minimum net worth requirement of 6%. After accounting for all of the identified key risks and opportunities, this financial institution is left with a 0.95% net worth cushion, beyond what it has established as its minimum threshold.

The current total net worth provides adequate coverage. However, it could also work out that the analysis identifies a need to focus on increasing total net worth in anticipation of risks and opportunities, or perhaps to take steps to mitigate the anticipated impacts – any key risks or opportunities could be included.

Quantifying major identifiable risks and estimating costs of strategic opportunities can enable leaders to better understand the viability of long-term strategic endeavors. It can also signal an early indication that net worth may need to be shored up to effectively support the credit union.

The Optimized Business Model

Indications are that the speed of change will continue to increase. Consumers are increasingly comparing their experiences outside the industry and expecting similar experiences with their financial institution. Non-traditional competition is targeting the more profitable parts of banking structures and their inefficiencies. Some disruptors may even be willing to forego earnings, seeing greater value in the data and relationships they can acquire.

More often, financial institutions will need to circle back and revisit their fundamental business model strategies to ensure they continue to remain relevant to their membership. Finding opportunity in the future will be more assured through continued optimizing of the entire business model; developing a strong link between the primary business strategy, the business model, the talent, the execution, and of course, desired financial performance within risk tolerances so that the cycle can continue.

The future will be a threat to some and an opportunity to others. It is most likely to be an opportunity for those who embrace uncertainty and are forward-thinking and intentional about optimizing their business models before it is necessary. As we said in the beginning, success in the future is likely to depend on the business model decisions that are made today.

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