Focus on Operational Agility to Achieve Success in 2024

Budgeting and planning for 2024 has proven to be a challenging exercise for banks and credit unions. The new year portends a host of unknowns, including, but not limited to, legislative and regulatory intervention, the resiliency of credit quality, and an unclear economic trajectory. This murky outlook made it daunting for management teams and boards to confidently determine a strategic course – or budget appropriately for it.

"Uncertainty is our biggest challenge," Jim Reinets, president and CEO of Insbank in Nashville, Tenn., recently stated during a conversation at the American Bankers Association Annual Conference. "There's no stable ground to plant your feet and push off."

While uncertainty is the big expectation in 2024, bankers do have opinions on what areas are most concerning to them. A recent survey by the Conference of State Bank Supervisors found that 89% of community bankers view net interest margins as an extremely important or very important risk, followed by the cost of funds (87%), core deposit growth (84%), and regulation (81%).

At this juncture, the general expectation for 2024 is that growth will be slow and extraordinary effort will be needed to meet revenue and bottom-line targets. SRM turned to its in-house experts, particularly those engaged in critical projects with bank and credit union clients, to ***look at several areas of consideration that could provide that extra edge toward meeting your numbers in 2024.***

Undertake a Digital Maturity Assessment

Cody Harrell, Managing Director – Community Financial Institutions

A maturity assessment of your digital infrastructure is vital, regardless of where you are in the budgeting process – or if you have moved on to the execution phase. An effective approach begins with an unvarnished appraisal of your financial institution's market position and digital footprint, along with a clear schematic of where you need to be.

Mapping where you are, where you want to be, and who you compete against should generate a list of actions necessary to close any gaps, including decisions on acquiring know-how (through hiring or M&A) or developing capabilities in-house. Avoid aiming for perfection – a recipe for paralysis – and instead realize there will always be changes as the market and technology evolve. All financial institutions must decide where they want to be in the near term, keeping in mind positioning in a competitive environment.

The process starts with a current state, organizational design, and capabilities assessments before moving on to developing a future state roadmap and strategy. Banks and credit unions can then determine if they're aligned with the best partners and if new collaborations are needed to reach an intended objective. A resulting digital assessment not only serves as a guide for execution, but it can aid in the messaging to your executive team, board, or leadership committee.

Along those lines, financial institutions should continually perform deep dives into consumer behavior, allocating funds to better understand their customers and members. Engage with your customers and members to better understand their needs and pain points and be willing to fund marketing programs.

Align with outside partners to address any gaps in your products and customer services, and influence usage in the most-profitable offerings. Identify the top merchants in the portfolio, including those who may be gaining or losing traction, and selectively invest in rewards programs.

Continuously Monitor Expenses

Mark Mrva, Senior Director

Financial institutions should closely scrutinize expenses to ensure they are market-competitive while exploring avenues to contain or reduce them. Functional managers responsible for area budgeting tend to focus on existing costs and invoices, but not the underlying contractual terms and conditions. This type of run-rate analysis is likely insufficient and remains subject to multiple blind spots.

Recent clarifications in the Durbin Amendment's e-commerce card routing rules are expected to trigger a rise in fraud. This will increase dispute volumes, a process that is already a pain point for many banks and credit unions. Consider revisiting opportunities to automate the associated back-office dispute processes, reducing the near- and long-term burden. Any investment into automating manual processes deserves scrutiny – projects should be considered and pursued if they free up time and money that can be more effectively deployed elsewhere.

Another key cost-control consideration is inflation. FIs can expect to face rising costs for services in a variety of areas such as janitorial services, telecom providers, chips for cards, ATMs, and other types of equipment.

Many vendor contracts have COLA (Cost of Living Adjustment) clauses that may have gone unnoticed for years. Some of these added costs may already be appearing as a line item on invoices; others may be structured as an annual price adjustment – driving a bigger one-time jolt down the line.

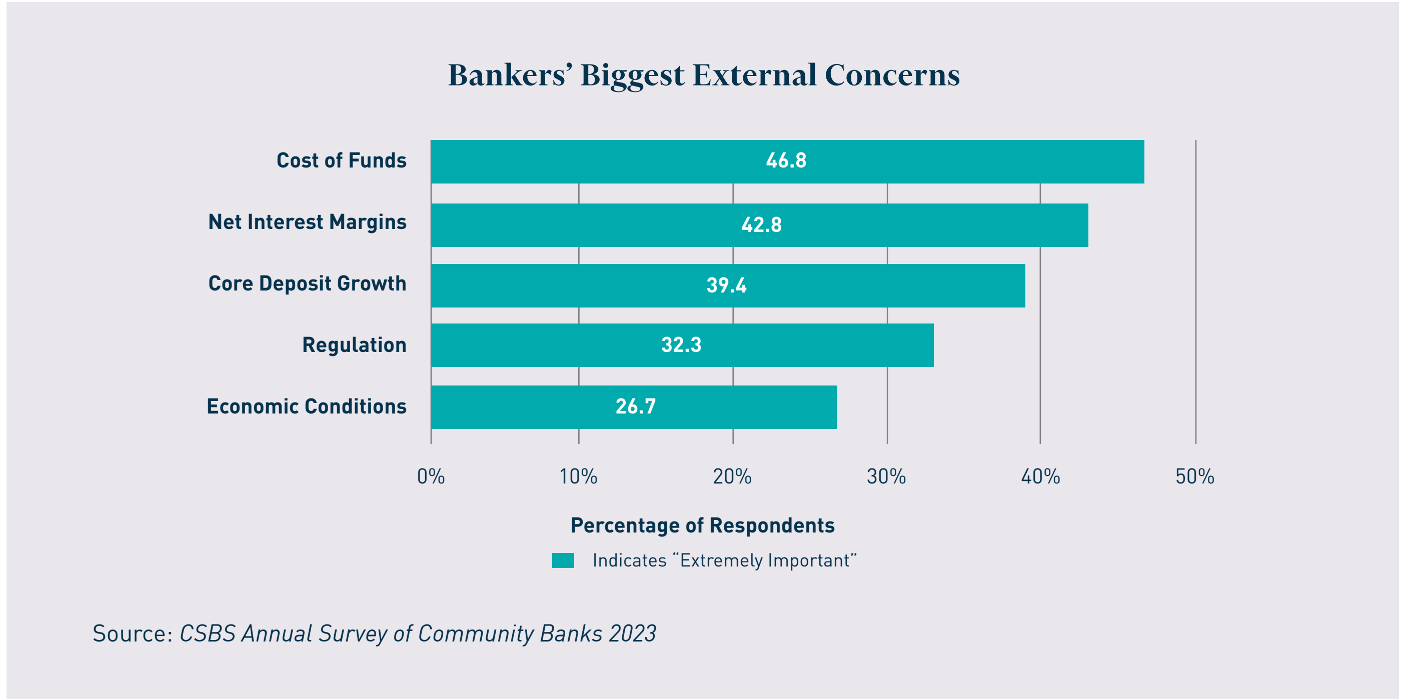
Third-party agreements often have escalators that increase across-the-board costs based on the Consumer Price Index (CPI), leaving financial institutions exposed to lingering inflation. A five-year agreement or proposal that looks good on paper likely does not model these increases. With that in mind, financial institutions need to prepare for those adjustments – or explore ways to manage or eliminate them.

Cost protection requires an expert to review contract clauses. Lawyers can be skilled in drafting vendor agreements, but very few are equipped to identify which clauses reflect common practices.

Any contract within three years of its expiration date merits a thorough review. Effective negotiation requires the vendor to understand that the financial institution has alternatives to renewal. Many entrenched vendors – particularly in IT and customer-interfacing roles – require a surprisingly long lead time to replace.

A robust RFP process, whether to gain negotiating leverage or to seriously consider alternative providers, frequently requires a year or more to execute properly. Often, such looming expirations go unnoticed until a budget process, at which point it is too late to act.

As always, financial institutions should anticipate the need to invest in staffing and technology. This matters now more than ever, given a competitive hiring environment and consumer demand for more sophisticated digital products.



Source: *CSBS Annual Survey of Community Banks 2023*

Come to Terms with Artificial Intelligence

Connor Heaton, Vice President – Intelligent Automation and AI

The White House recently unveiled an executive order for artificial intelligence (AI) that provides more rules of the road for the use of AI. Financial institutions should take note as they finalize preparations for 2024.

Some highlights include requirements for US-based AI and cloud hosting companies to tighten security provisions and report on certain very large projects, as well as requirements for entities that rely heavily on AI, and requirements for various federal agencies to layer on more rules, regulations, and parameters over time.

We've seen significant functionality gains in OpenAI's offerings over the last six months, to say nothing of the evolving ecosystem. Even where the language of the executive order is on target and appropriate, agencies will struggle to keep up. So much of the regulatory space would ideally be highly responsive to new developments, which is seemingly impossible given how most agencies are set up today.

While there is some concern that the burden of navigating a new, complex regulatory environment will stifle innovation and open-source development, there is broad consensus that regulation is important and necessary. The AI order represents a more-substantive stance on regulation than any we've had from the US to date. It should at least start the massive cogs of government moving to produce some form of regulation.

The pace of change in AI demands highly responsive regulation, and agencies will struggle to keep up. The executive order sets deadlines for a long list of agencies to publish guidance. While it requires that they coordinate with industry and each other, we expect the result will be largely broad, light-touch, non-binding guidance that covers primarily obvious pitfalls.

Regulation will likely emerge in an initial patchwork that will be refined over time in response to incidents in the industry. Meanwhile, the recent leadership power struggle at OpenAI is an important reminder of the volatility that can take place at the giants in the AI space.

In the indefinite meantime, Silicon Valley races on. Financial institutions should take note and educate themselves on the risks and opportunities of this emerging technology.

Decide on Complex Core Processing Platforms

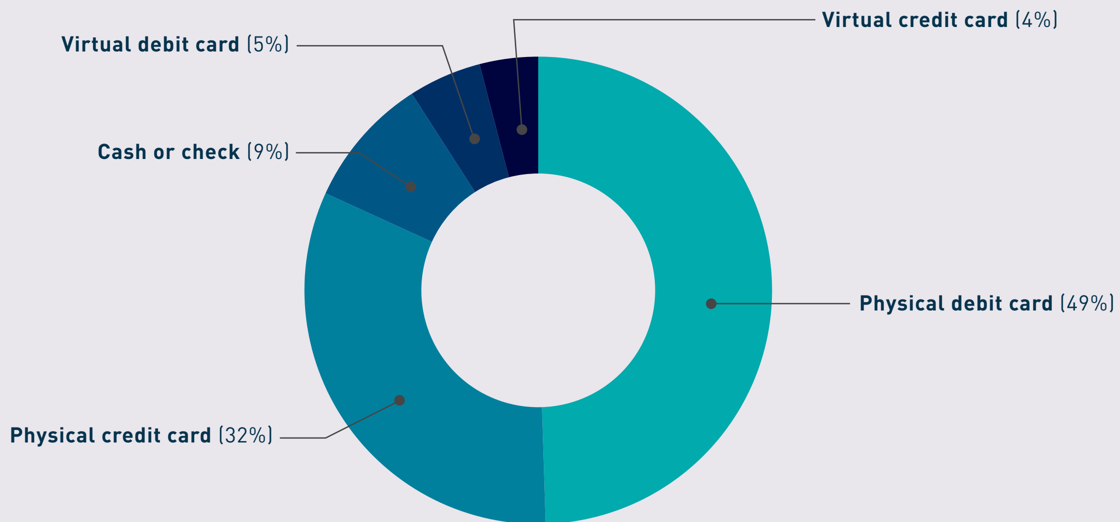
Mike Langenkamp, Director

The issue of core processing platform modernization has been a key concern at financial institutions for years. For many, it seemed like a choice between subpar alternatives. One option has involved embarking on a time-consuming and expensive replacement of an outdated system, with a significant risk of customer disruption. The alternative has been to remain hamstrung by an existing system that severely limits both the number and timing of new service rollouts.

Ongoing advancements in technology have created a third option, prompting FIs to revisit their options. Many are exploring whether to hollow out their existing core configuration – leaving it in place for basic functionality like calculating interest and applying loan payments – while implementing a middleware layer to enable a progression of new capabilities. This is sometimes referred to as a "sidecar core strategy."

This new approach involves a substantial investment of time, resources, and precious employee bandwidth, so the decision deserves careful consideration and analysis. However, the middleware option requires roughly half the time and cost of a traditional "rip and replace" of the core processing platform – with virtually none of the customer impacts such as weekend downtime, card re-issuance, or the resetting of credentials.

It's somewhat ironic that middleware may ultimately extend the lives of legacy core systems that have long been considered antiquated impediments to the rollout of state-of-the-art banking services. Even if a bank eventually proceeds with a full core replacement, the sidecar approach can make the undertaking less burdensome and nerve-wracking.



Adjust to Shifts in Debit Routing

Russ Bourne, Chief Operating Officer

Financial institutions should examine the routing of their card transactions, keeping in mind the overall impact on interchange revenue. We've seen a shift from signature to PIN transactions, led by an acceleration in e-commerce that began during the early days of the pandemic.

Virtual debit and credit cards account for nearly a tenth of all consumer purchases, according to a February 2023 Forbes Advisor survey. That percentage is expected to grow.

A thorough review can help determine your relative share of signature vs. PIN transactions, allowing you to model and develop strategies for 2024 and beyond. Keep in mind that signature transactions can generate higher interchange fees than PIN transactions.

While banks and credit unions with $5 billion or more in assets may have the staff necessary to handle such analysis, all financial institutions can benefit from seasoned expertise.

Financial institutions must realize, too, that modeling should be based on current trends and historical data. Changes in shopping patterns may elevate new merchants to the top of activity logs. Geography also plays a role in portfolio optimization, as different networks may offer better coverage in certain parts of the country, or with certain business categories.

We advise evaluating a recent Fed rule change, which took effect in July, that requires at least two unaffiliated networks be made available for routing all transactions to include card-not-present debit transactions. This distinction can have significant revenue implications, given a rise in e-commerce, serving as a reminder to ensure that your card routing strategies are optimized for present-day conditions. A key is to create programs where cards are being used in ways that are most beneficial to your financial institution.

Card-not-present transactions have comprised a growing share of volume for some time, driving a gradual shift from dual-message transactions to PIN networks that goes back to late 2022 and could reflect networks preparing for (and acting in advance of) July's effective date.

Although Reg II has constrained options for managing an effective routing strategy, several steps can be taken to improve performance. Big merchants, who stand to gain disproportionately from recent and pending changes, are certainly scouring the fine print for any advantage. These involve granting select networks some volume assurances in return for a preferred rate. In a high-volume area like interchange, small changes in unit price can quickly accumulate to meaningful P&L impact.

Understand Fintech and Delivery Models

Keith Ash, Managing Director

The continuing evolution of the fintech industry is delivering an ever-increasing array of innovative solutions that the major core processing platform providers are slow to keep pace in terms of integration. The ability of financial institutions to differentiate themselves and offer essential self-service capabilities is becoming even more fundamental to success. FIs need a more nimble approach than what the major providers are able and willing to provide – as they are called upon to support hundreds of solutions, which provides a one-to-many approach versus a customized solution.

For strategic reasons, a financial institution's focus should be on customer-facing solutions with best-in-breed products. A critical question becomes whether a financial institution can regularly access data from its core – both extracting it to populate adjacent systems and feeding enhanced info back into the core. This seemingly basic task is often not as straightforward as it sounds.

Many vendor contracts include longstanding provisions requiring financial institutions to pay for access to their own data. It's essential to break free of this "pay by the drink" model. Potentially even more damaging are exclusivity clauses or stringent minimums that could even preclude the option, in theory, of using multiple solutions that allow a financial institution to become less reliant on just one vendor.

Financial services delivery models have evolved so rapidly that seemingly innocuous language from a decade ago may now carry added meaning. It had been common for core providers to include boilerplate contract language requiring clients to adopt their offering rather than a similar in-market solution – even if the incumbent's product was inferior or didn't exist at the time of contract execution.

A telltale sign to watch for is the use of the language "then current" in a contract. It is broad and imprecise by design and essentially serves as an invitation for future disputes. "Like or similar services" is another yellow flag.

As new fintech solutions continuously enter the market; if they weren't differentiated from existing offerings in features or performance, they'd stand little chance of success. Nonetheless, vendors can deploy this terminology to demand the use of their product in the general field. Most vendor contracts include such clauses, often without clients realizing it or understanding their implications.

Flexibility is more important than ever as financial institutions evolve to meet the needs of their customers. No processor has a best-in-breed solution for all of these changing needs. Financial institutions should focus on having the right level of flexibility to achieve the speed of innovation it desires.

Summary

Success in 2024 will be a game of inches rather than yards. Incremental revenue gains and controlling expenses will be critical to closing in on budgeting goals, achieving shareholder returns, and improving product services for customers and members.

High interest rates, economic pressure, and hiring challenges are likely to persist for most of next year. Finding ways to tap into AI, keeping a close eye on expenses, and evaluating and understanding your fintech strategy can be the difference between meeting or falling short of your strategic objectives.

Remember that success goes beyond a rigid budgeting process. Financial institutions that make the right adjustments over the next few months will be poised to improve their delivery channels and gain market share.

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