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AN EDGE CONSULTANCY, LLC NEWSLETTER

CHANGES IMPACTING CREDIT UNIONS TODAY
KETPLACE LENDING: DISRUPTING THE DISRUPTORS

Written by: Donnie Price, Senior Consultant, Edge Consultancy

By now it's a familiar story, but the story's unfolding details continues to create newness and change at an unprecedented speed. Part of the story consists in the continuation of industry consolidation and the search for efficiencies. Scale increasingly matters. What also endures is the industry's commitment to cooperative ideals and support of small credit unions.

Nevertheless, per the 2016 CUNA Economics and Statistics report, we lost 237 credit unions in 2016, leaving us at 5,906 total. Even so, as in recent years since the Great Recession, the industry continues to grow in members (108 million as of 2016 year-end versus 91 million in 2010) and assets ($1.3 trillion as of 2016 year-end versus $927 million in 2010), but most of this growth is restricted to credit unions in the $500 million plus asset range with those over $1 billion growing at an even faster rate. This is not to say that there are not credit unions in the smaller asset classes without good performance numbers, but the data makes it clear that size increasingly matters. The ongoing, exciting part of the story revolves around continued technological developments and applications, and, as many are experiencing, this technology disruption seems to be forever driving change.

In surveying the environment, one may become easily overwhelmed by the size and number of significant changes and challenges being faced by credit unions today, such as an increasing number of disparate systems and solutions to manage, new entrants to the marketplace, non- interest income pressures, expense reduction measures, brand and loyalty deterioration, regulatory burdens, cybersecurity enforcement requirements, and strategy execution amid a changing economic and regulatory climate - just to name a few. One consistent driving force, however, which inspires almost all this change, continues to be ongoing technology disruption. Technology disruption in banking manifests itself in real change and opportunity in all

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areas, both external and internal facing. These include changes and opportunities in member service, loan origination, new account acquisition, business processes & workflows, business intelligence, information security, dynamic risk mitigation tools, product development, changing revenue streams, etc. Financial services and technology enablement are inseparable today, and its convergence cannot be overstated. Nevertheless, the primary focus remains steadfast - serving members' financial needs - and leveraging technology makes this possible on a scale and at a personalized level previously unknown. Technology disruption is also a threat, however, and when thought of in this way it is often referred to as digital disruption. FinTechs and digital-only banks are on the rise. Digital technology has reduced many of the old barriers of entry within the retail banking space. Furthermore, the OCC has recently announced its bank charter granting authority for FinTech companies willing to undergo regulatory scrutiny. By being designated as a national bank, these alternative banks will extend their reach by providing confidence to investors and consumers.

These new entrants compete directly for payments, loans, and deposits while leveraging the latest technology without incurring traditional expenses such as branches, personnel, and legacy IT infrastructures. They're able to provide more convenient and cheaper solutions in many cases. Furthermore, unlike credit unions, many of these providers today aren't laden with the same level of regulatory burden and imbedded culture that often stifles innovation.

Interestingly, 49% percent of banking executives, according to The Economist's 2016 report, "Retail Banking: In tech we trust," say traditional transaction/branch based banking will be dead by 2020.

Equally important is the technology revolution occurring in data-driven predictive analytics and actionable insights. Credit unions have the decided advantage here, if only they execute. Credit unions possess enormous amounts of account and transactional data on their members, and this data represents the raw material needed for increased business intelligence. In this sense, credit unions, rather than FinTechs, are better positioned to anticipate needs. Potentially, this data provides market knowledge, member insights, enhanced service, and individualized offerings.

While most of these technological advancements lead to increased opportunities, technology sprawl, if not managed strategically, can often result in technology debt. Technology debt is defined as the inefficiencies, duplicate processes, and extra work created by an outdated or out of control technology architecture. This is a growing concern for most all credit union leaders. Streamlining operations, integrating systems, managing expenses, and creating frictionless and engaging member journeys are required to compete more effectively today. With disparate systems and one-off applications, point-solutions, silos of data, and disjointed business process, a credit union can't compete in the future of banking, even with the addition of new digital tools and enhanced delivery channels. FIs need IT leadership that can reduce the elements of technology chaos through prioritization, discipline, and strategic focus. Poorly planning technology evolution is costly, and will most certainly damage a reputation, internally and externally.

In summary, technology enabled solutions are delivering enormous, competitive advantages as well as increased member benefit. On the other

hand, this same technology is permitting new and more nimble competitors to enter the market. The pace of technological change is accelerating, too, which puts more pressure on planning rightly. Credit unions will be served better by taking a strategic view to managing a response to digital disruption and technology enablement. The approach should always encompass at least these three key components:

1. Member Centricity - focus on the member journey and experience.
2. Business Process Optimization – continually improve processes and services as technology platforms evolve.
3. Business Intelligence - use data analytics to personalize experience and optimize touch points.

BLOCKCHAIN IN THE CREDIT UNION MARKET: *Controls Discussion*

Written by: Ray Seefeldt, Senior Consultant, Edge Consultancy

The concluding statement in our introductory article on blockchain from Edition 2 Volume 1 of our Newsletter was:

The current state of blockchain does not include controls necessary to manage associated risk

In this article, we will explore one area – the software and hardware of blockchain. The perspective will be – what type of controls should exist specifically related to coded processes (software, hardware, etc.).

From the recent Harvard Business Review article on blockchain control:

Code is law for machines.

The basis for a controlled or trusted system is adherence to the law. For the system to work, there must be a level of assumption that the law will be followed. The HBR article further states:

In a blockchain transaction, you don't have to trust your counterpart to perform their obligations or properly record transactional data, since these processes are standardized and automated, but you do have to trust that the code and the network will function as you expect.

You do not need to trust your counterpart? This is true if they have installed and are current on all components necessary for the process to function as expected. When the counterparts (aka network nodes) number in the thousands, that's a lot to trust. Historically, "trust but verify" and "prove it" processes have been used to create processes and networks that can be trusted.

Blockchain is not a true black-box (throw in data and if what was expected comes out, it works), particularly with the miner function. Therefore,

For the network (code and related hardware) to be "trusted" it must include:

- Installation and Use Instructions – regardless of the sophistication of the process and procedure, there will be people involved in installation, configuration, etc. The people will need to be supported and the supporters need to be able to say, "read the manual".
- Software Inventory Control – all components that comprise the blockchain "application" must be clearly available to all participants/nodes in the network – we all must install the same software.
- Hardware Requirements
- NOS Requirements
- Change Management – proceeded by a process for the development/change of code:
  - Why change
  - Authorization
  - Requirements – it did this, now we want it to do this
  - Testing – how do we know it is doing what we wanted it to do and will it work with all the other stuff out there?
  - Validation and Acceptance – does the network believe that it works?

- Code Security – limitation of and processes for who can change the code and when
- Code -1 Invalidation – one of the challenges in insuring that all of the code running on all of the nodes in a network is all the same, is that most often -1 or lower states of the code work for 99%+ of the functions, or often kinda-work for all functions. The best way for a network to know that all the code is current on all nodes is to "blow-up" the -1 and older code.
- Evaluation by an independent third-party who will have "skin in the game" (if they mess up they have the resources to make the parties in the network and their customers whole – you can sue them and they can cover it).
- If every one of the controls above does not exist in the network, transactions can be repudiated.

Adequate control structures are a blockchain imperative. Developers and users of blockchain technology must understand and support efficient and effective controls.

We have been impressed with the CULedger project. Leveraging the credit union network to be a blockchain network, with structure, verifiable miners, and transaction control continuity appears to be possible with this platform. The credit union industry has a history of implementing well controlled business transactional processes. Taking the lead in blockchain is encouraging.

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Contact Edge Consultancy LLC:
Brian Molloy
Miami Beach, FL
Email: contact@edgeconsultancyllc.com
(866) 499-6430 ex: 704