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**Staying Relevant in the Era of Disruptive Innovation TRANSCRIPT**

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**Nathan:** Good day, and welcome to Harland Clarke's The Informed Banker webcast: Staying Relevant in the Era of Disruptive Innovation. This webcast is being recorded and a replay will be provided to you within a few days. If you have questions, please use the chat box located in the control panel. The questions are private and are only seen by the presenters. I will now turn the call over to Christine Ahlgren of Harland Clarke. Christine, you have the call.

**Christine:** Thanks, Nathan. Welcome to everyone who's joined us today for this month's installment of The Informed Banker. This series is designed to bring you succinct and timely information on topics that are critical to community financial institutions. Today's session, Staying Relevant in the Era of Disruptive Innovation, will be presented by Jay Johnson of Callahan & Associates to help innovate new ways to not only survive in today's environment but to develop new opportunities to stay relevant with the consumers.

Jay's a Partner at Callahan & Associates and a respected credit union strategist. He is a leading industry voice continually sought out for his insight. Jay, welcome. My first question to you today is this. We hear that term disruption quite a bit today. It's finding that a lot of FIs are really concerned about disruption to their business. Can you provide perspective as to why this has become such a buzzword?

**Jay:** Sure, Christine. Thank you and appreciate everyone joining us. Maybe before I dive into the question, I'd like to first put up one of our poll question here to just have people identify how they're thinking about the market today. As they think about their future, what do they see as their biggest threat to their future success and their sustainability? We've got some choices here: large FIs; community FIs; FinTechs; or maybe just your own institution. Can we evolve with the market? How quickly can we? Can we do it in a way that's relevant to the consumers that we serve?

We'll take the poll first. Then I'll move forward. Okay, interesting response; interesting. Three-quarters are thinking about it more internally. As we talk today, I think this will maybe give some folks some guidance as to how they can reshape how their institution thinks about their own evolution. Let's move to the first slide. We're going to show – maybe go back one. Going to show some organizations – oh, okay. Okay, yeah, sorry. Go ahead one more than.

The term disruption is one that really plays not only in financial institutions, but really in the market as a whole because we have seen throughout history and almost more so in recent history the way once vibrant companies can fade away. You think about the names that you see up here like Kodak or Sears; still around but certainly not what it used to be. Maybe more recently, a Toys R Us. These are all companies and brands that meant a lot to the market and to consumers, but for various reasons have become a historical footnote.

In financial services, you see Bear Stearns up there where it's our 10-year anniversary of Bear Stearns and Lehman Brothers going away. Names that on Wall Street for years carried a lot of weight. Disruption is a buzzword. There's no doubt that the environment around us and some of this change we see in the marketplace is a driver of that. Let's move to the next slide.

One of the things Callahan & Associates has been working with the market with is utilizing the teachings of Clay Christenson. Clay is a professor at the Harvard Business School. He's the author of *The Innovator's Dilemma*. One of his most famous books but certainly it's considered one of the leading business thinkers.

As we look at the market, we think a lot of what Clay teaches can help financial institutions as you said, Christine, not only just survive but really thrive, and understand and develop new opportunities that will help them stay relevant to consumers. The focus Professor Christenson's research and teaching has been on trying to answer the question, why do good companies fail? Again, looking at that market turnover we just saw, it certainly seems like a good reason to be looking at that research. That's what we want to talk about today.

**Christine:** Jay, it's interesting the word disruptive often comes with some pretty negative connotation. What you've just described and what I expect you'll continue to talk about is the benefits that we can gain through the inner market with this type of a strategy. Do you think there's a better way to position that? Is there a better word to describe disruptive that has a different feel to it?

**Jay:** Yeah, absolutely. I think it's a term that we see a lot today in writing and then in speeches and presentation. Disruption is maybe overused in the market today. Professor Christenson brings a way of thinking about disruption that I think can be helpful. Let's go to the next slide.

The first type of innovation – and when I say innovation, disruption, in some ways they're parallel. You can use it as one word, disruptive-innovation. The first type of innovation that is talked about in Clay's work is what's called sustaining innovation. This type of innovation is going to be led by an industry leader. These are the companies that want to continue to develop leading products for their best customers. They do this because they want to maintain not only their leading position in the market but also their margins because they know that the best customers will pay a premium price to have that leading-edge product or service.

We show on the chart here the iPhone. This goes back about a year. Obviously, we've just had Apple's most recent announcement. It continues that path of sustaining innovation: $1,000 plus for their latest phone. Again, those will be bought by a certain segment of the consumer that always wants to have that leading technology. Sustaining innovation is what the incumbents typically bring and market leaders typically bring to market on a regular basis.

Now, being a market leader also though puts you at potential risk of disruption. Now, let's look at the next slide. This slide shows two lines. The top line relates to that sustaining innovation I just talked about. You see performance continues to increase over time. This is the idea of continuing to push a product higher and higher, greater and greater capabilities, ideally greater value for those top-end customers in particular.

As you look at this chart, you can also see that there's some dotted lines. You can think of those dotted lines as different segments of the consumer market and their perception of the value of the capabilities of these products. At some point, the performance of these products exceeds what people need or what they're willing to pay for. This creates an opportunity for another firm to come in and deliver a product that meets the needs of these consumers that are overserved by that market leader. This is what we call low-end disruption.

It's an opportunity for a company to come in with what Professor Christenson refers to as a good enough product. It performs good enough for the consumer. They don't need all the bells and whistles. They don't need the two cameras on the iPhone. They just need something that serves a purpose for them. They key here is that when you're looking at the marketplace, you may be in some products and services may be considered being incumbent. What you've got to look out for is the possibility of another company coming in, a competitor coming in, and being that low-end disruptor. Maybe they don't offer the full range of services, but for some segment of the market, that may be all that's needed.

Secondly, you may be able to look at the market as a potential low-end disruptor and say, you know there's an incumbent here in the market that's providing a lot, charging a lot for some segment of the market. We think there's an opportunity to come in and serve that market in a better way, a lower cost way, and win some business away from them. You see this I think in community institutions particularly around say small business funding where some of the large FIs may have moved out of the market or maybe continue to move up in the market. There's an opportunity for community FIs to come in and be that low-end disruptor and offer a better value and a more accurate – meet the needs more accurately of those customers.

You can see this play out, maybe a good parallel, if we go to the next slide is the example of the car industry here in the US. This is a long-term trend here from the '60s. As we know, GM used to be the dominant player; had half the market share. Then you had the Japanese automakers coming in the late '60s, early '70s: Toyota, Honda, Nissan. Coming in with these cars that were smaller, that didn't have a lot to them, but they got you around.

That idea of being good enough certainly started to attract consumers. Obviously, we know over time how the market share dynamics have changed in the US market. This is a way that type of low-end disruption might play out in the market. The key here is that it's a zero-sum game. Everyone is fighting for the same market share. When you talk sustaining innovation versus low-end disruption, one person is taking business from the other or one company is taking business from the other: zero-sum game.

Now, there's a third type of disruption that's also important though. Let's go to the next slide and we'll show you that. Now, I apologize for those of you who might be eating lunch because I know this picture isn't the most attractive. The example here for new market disruption would be – the idea of new market disruption is that you're expanding the market. That consumers are thinking of different attributes as to why they would buy a certain product or service.

The example we're showing here is teeth whitening. Some people on the right might choose to go to the dentist, pay thousands of dollars, and go through a series of treatments to get your teeth white. Here then Crest comes out with their white stripes. There's a lot of people who had no interest in paying a dentist for that service and sitting in the chair for that long. Boy, you can stick one of these on your teeth and get white teeth? Sure, let's do that.

That probably brought in a whole different range of consumers to the product or service. That's what we mean by new market disruption. It's expanding the market on a different attribute. Three types of disruption that Professor Christenson identifies: sustaining innovation, low-end disruption, and new market disruption.

**Christine:** Jay, that really helps us understand the competitive landscape. Now, I would ask, how do you think institutions know or what actions they need to take to ensure they're adapting to that changing consumer need?

**Jay:** Sure, well, let's go to the next slide because I think what we're talking about here is innovation. How do you innovate to the market? In many cases, innovation has a connotation of being a risky proposition. To some extent, that is going to be true. There are ways you might try and not succeed in a sense. If it's done right, innovation can lead you to the right response to solving a consumer's need or problem. That's ultimately what innovation is. It's just solving a problem that a consumer or a business has.

Let me illustrate an example of this if we go to the next slide. This is actually an example from Professor Christenson's work; In fact, some of his early work. He was hired by McDonald's, he and his team, to understand what was happening in the milkshake market. What they found as they looked at the research was that they had a couple of stores that milkshake sales were through the roof compared to other stores. The milkshake machine was a very underutilized machine at McDonald's. McDonald's wanted to figure out how do you optimize this a little more.

As they did their research, they went to these franchises that had these strong sales. They just sat and watched. One of the unique things was that these franchises were selling milkshakes in the morning. There were all of these people that would come in the morning, get a milkshake, and get back in their care and leave. What they learned was that these consumers were coming in because they had a long commute. They wanted something to slurp on during their long boring commute to try and keep them occupied in some way.

It's first thing in the morning. They also want to wake up, so it gives them a little bit of a sugar rush, etc. What came out of this was a different way of thinking because McDonald's would have never thought that they were competing as a breakfast item with a milkshake, but they actually were. The interesting side note here is that McDonald's ignored the research and Clay and his team went to Panera with the idea of the smoothie in the morning as a substitute. Panera became a big seller of that. It took McDonald's a number of years to get back into the smoothie business – or to get into the smoothie business. Now, they're the largest seller there.

The idea here is what Clay identifies as what's the job that a product is trying to solve from a customer's perspective. The key is that it's from the customer's perspective. In this case, McDonald's probably thought they were competing against Burger King and Wendy's in the shake market. The reality was in the mornings, they were actually competing against Dunkin' Donuts and Starbucks and others; Starbucks wasn't really around as much back in that time.

That was a different kind of competitor, but from the consumer standpoint, the job was the same. They wanted something to occupy themselves as they commuted to work every day while filling a need for a meal. This idea of understanding a job and really understanding what the customer wants, that's what innovation is all about. What are they trying to accomplish? How can you help them do that better?

If you go to the next slide, there's other ways we can think of this happening in the marketplace: Snickers versus Milky Way. In some ways, they're both candy bars, right. In other ways, I think Snickers doesn't necessarily view itself as competing with Milky Way bars because if you go to the next slide, and you reflect on the way Snickers advertises their product, it's not a candy bar; it's a mini-meal. They have positioned themselves to fulfill a different type of job than a Milky Way. They're not trying to solve for a sweet-tooth; they're trying to solve for hunger and getting something filled up in your stomach to where you can move forward with your day and not be worried about being hungry. That's another type of job in the way they've positioned themselves in a different way.

Now, let's bring it back to our world as we go to the next slide. In our world, certainly, you see a number of these startups in the financial services world that you're probably all familiar with. They too are taking this same idea of identifying a customer's job and solving it. Let's take some examples here. You've got Simple there. Simple is solving the job for our customer of I want an easy, low-cost way to manage my spending. If you know Simple, it's just a very straightforward all online and debit card checking account.

Venmo, I want an easy and quick way to pay back my friends. Of course, they incorporate some social networking and social media as part of it, too. Bottom line is it's a way to help those friends transfer money to each other. SoFi, certainly, they focus a lot on I want to consolidate my debt, so I can save some money. Here in Washington D.C where I'm located, they advertise on the metro all the time and it's all about saving. These are the jobs that these firms have identified. The key is they've listened to the market, and acted, and focused their product and service design all around that.

**Christine:** Wow, Jay, you've given us a lot of really valiant examples of how companies have identified and solved these innovation problems. From the perspective of a community financial institution, how would you recommend that they incorporate innovation into their own organization's culture?

**Jay:** Sure, absolutely, because that's the key here, Christine. That's what we're trying to accomplish. Let's go to the next slide. Because the reality is there is a very defined way of identifying jobs that some firms will actually help you with. That's not our business, but there are consultants that will help you at their firm.

The key is listening to the market. There's different ways that you can do that. Generally, if you listen to or put yourself in the customer's shoes, you can think about it as starting with a phrase like help me do X, or I want to avoid doing X, or I need to do X. Just starting to think that way and use those phrases are important. Again, all you're trying to get to is what is the consumer trying to achieve? What are they trying to avoid? Putting yourself in their shoes.

As you think about it from a financial institution perspective, we have a lot of opportunities to do this. You can talk to current accountholders. Your frontline staff's doing that every day. Maybe you talk to former ac-countholders, accountholders that may be leaving your institution, understanding why they're leaving you, and really trying to identify those jobs better.

We've got an example here from Langley Federal Credit Union in Virginia that we've worked with. One of the things that they did was they, as a lot of you do I'm sure, have regular meetings between the branch staff and then branch staff with some of their regional managers talking about what they're hearing. One thing that was happening at this credit union was that they found a number of the potential members that would walk into the credit union to try and get a checking account were getting turned down just because their credit wasn't what it needed to be. As they started talking about this and hearing the amount of declines they were getting, they thought there had to be a way to resolve this.

What they did was take that idea of the consumer saying, I need a basic checking account to help me get through my daily life because these people just didn't have a way to manage their money. They worked to develop a product with specific parameters that limited risk, but also provided essentially almost a credit builder type product for these consumers as they came into the credit union. Again, the idea here is it came from the frontline staff. They're the ones having the conversations, hearing the needs. That's what's important. As I think for each institution here, an example here is as you think about it is, what is your institution doing to capture information, share that information, review some of the questions, comments that are coming in maybe to branches, maybe to call centers, whatever it may be? This gives you an opportunity to do that.

I think one important point is they have this as part of a continuous process because I think that's important, too. If you stop doing it, you'd lose track of the market. To go back to Clay Christenson's question, why do good companies fail? It's because they stop listening to the market. Christine, I'll pause there.

**Christine:** On that note, Jay – yeah, I was going to say that's a perfect segue for us to go into a few questions that have been submitted by the audience. Before I start, just want to let the folks know if you do have a question for Jay in the next few minutes we have in this call, please use your chat box in your WebEX panel to ask those questions. We'll get to as many as we can. Jay, the first question I have here is: you have talked about innovation as it relates to consumers, but aren't there also opportunities for organizations to be working on innovation as it relates to internal processes?

**Jay:** Oh, yes, right. We have taken this as looking at the market perspective, but absolutely. You can take this idea of a job and think of that as an internal job, too. Internally, there's probably a lot of things that in your back office operations, people are saying, help me do X; or I want to avoid doing X; or I need to do X more efficiently. You can use this same approach and that same way of solving the problem to say, let's apply this internally as well as externally.

Again, the key is two things. One, just instilling in your team, your staff, to always be asking these questions. Always be trying to identify what are some opportunities to do things better or to avoid doing some things that create inefficiencies. Second important thing is just to keep asking those questions. Keep reviewing those questions. Keep filtering and prioritizing those questions. Absolutely, you can apply it internally as well as externally.

**Christine:** Thanks, I'm just going to keep at it. We have a stack of questions here. It seems like it is the larger companies that get identified as being the innovators. Can a community institution really make an impact given the limited scale and resources in that space?

**Jay:** Certainly, that is true. When you think of innovation, you think of Apple and Amazon, and maybe in our world, Chase or firms like that. You're right; those tend to be the examples that come out, but absolutely. In many ways, I think there's a real advantage to community institutions because again, you go back to the foundation of this, it's all about listening to the consumer. I think smaller institutions actually have a greater opportunity to do that and are maybe more adept at doing that. We all know how a real strength of community institutions is that ability to really know the customer, know the member. That's an important part of this.

I think as you think about starting with how do we understand the consumer better? How do we respond to them better? I think smaller institutions are a great place to do that. Again, they just need to be sure that they are always asking the questions, encouraging their team to ask the questions. Then from the management standpoint, paying attention to what they're hearing and acting on it. Any other questions that have come through, Christine?

**Christine:** Yeah, sorry. I have one right here. It looks like we have time for one last question. What would be a good first step an institution could take to begin the process of identifying opportunities for innovation? Where do they start, Jay?

**Jay:** Yeah, it's interesting because oftentimes management teams are the ones talking about this. They're the ones saying, how do we continue to be successful in our business. I think where it's most important is really talking to the frontline staff whether it's you're call center, whether it's your branch staff. Being sure they're asking the right questions. Being sure they're not ignoring some of the questions that come in because the reality is there's probably some real gems of information and real insights into opportunities.

You take the Langley example. Again, this was something where the staff identified that hey, we're turning down a lot of potential business here. How can we flip that? It's instilling that instinct in that staff. I think a big part of this is just talking to them.

Talking to frontline staff, being sure that they are thinking in this manner, sometimes that's easier said than done. Again, maybe going through the ways that Professor Christenson talks about it: help me avoid, I need to. Maybe have them just talk about what are you hearing from – when a customer or member comes in, what are you hearing from them and how much you translate that into one of those three phrases. Are there some things we can be doing as an institution to really meet some of those needs?

I think the one other thing I would say on this, Christine, is business has been pretty good for most institutions the last few years. The other important note is now is the time to do that because it's always easier to think about these opportunities and to position yourself better when business is going well because often, you have more of an opportunity to be a disruptor when you're in that position. Otherwise what happens is if a threat comes, it's too late. You've got to start doing it while business is good. Otherwise, that's when you are at risk of being disrupted. Generally, financial institutions are in good shape these days. I think it's an important time to start thinking in this manner to continue that success going forward.

**Christine:** Thanks, Jay. Unfortunately, it looks like we're at the end of time together today. I wanted folks on the phone to know that we'll be sending a follow-up email from Harland Clarke that will include a survey and links to today's recording and presentation. Please feel free to share that recording with any colleagues who may have missed today's session. We'd love to see you again on October 25th for our next Informed Banker presentation, Competing in a Land of the Giants, which will be presented by Jon Jeffreys also of Callahan & Associates.

Jay, thank you again sincerely for all you've shared today. I'd like to extend a very sincere thank you to the many financial services professionals who made time today to be with us. I hope to see you all again real soon. That concludes today's session. Thank you for joining us.