Lotus knows.

Smarter software for a Smarter Planet.

Winning in the “New Normal Economy”

Gary McBride | World-Wide Leader, Banking Web Experience Software

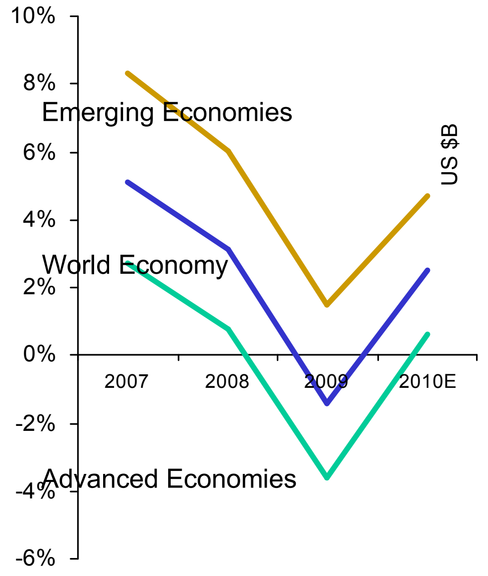
lotusknows.com

Agenda

- Fit Focused and Ready to Fight – How banks can get in shape for the battle ahead
- Smarter Banking – Software Frameworks enabling banks to meet these challenges

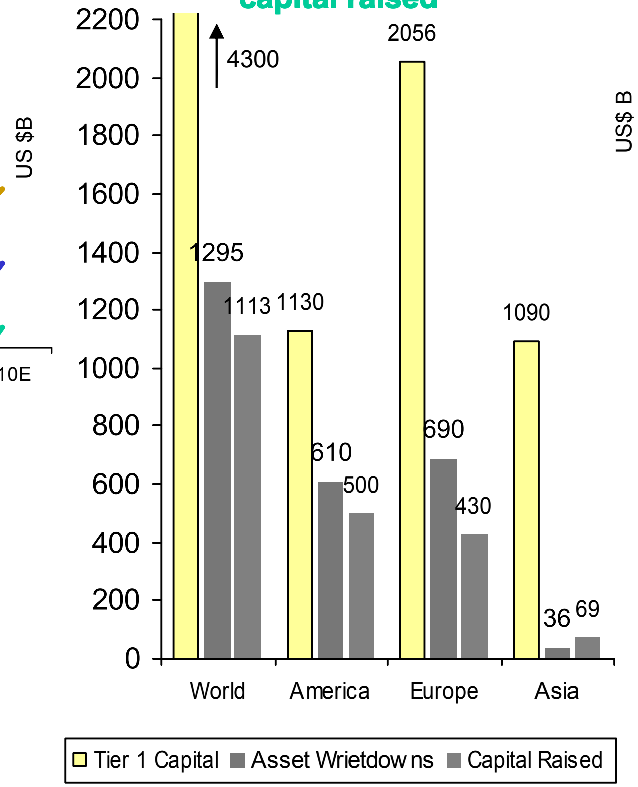
With the economy on course to a recovery, banks are faced with new opportunities and significant write-downs from the past

Gross Domestic Product
(2007, 2008, 2009-10E



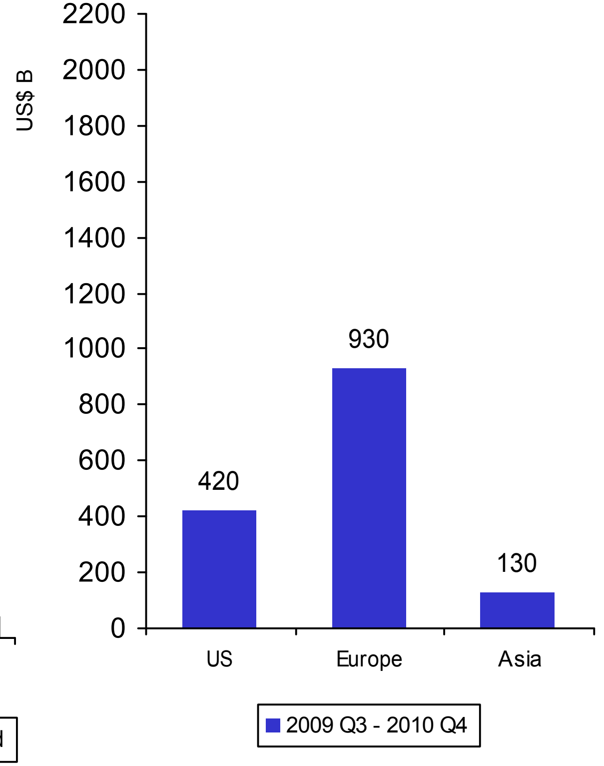
Write-downs & Capital Raised
Q2 2007 – Q2 2009

Write-downs exceed capital raised



FI[1] Future Write-downs
2009 Q3 – 2010 Q4E

An additional ~$1.5 T write-downs is expected[2]



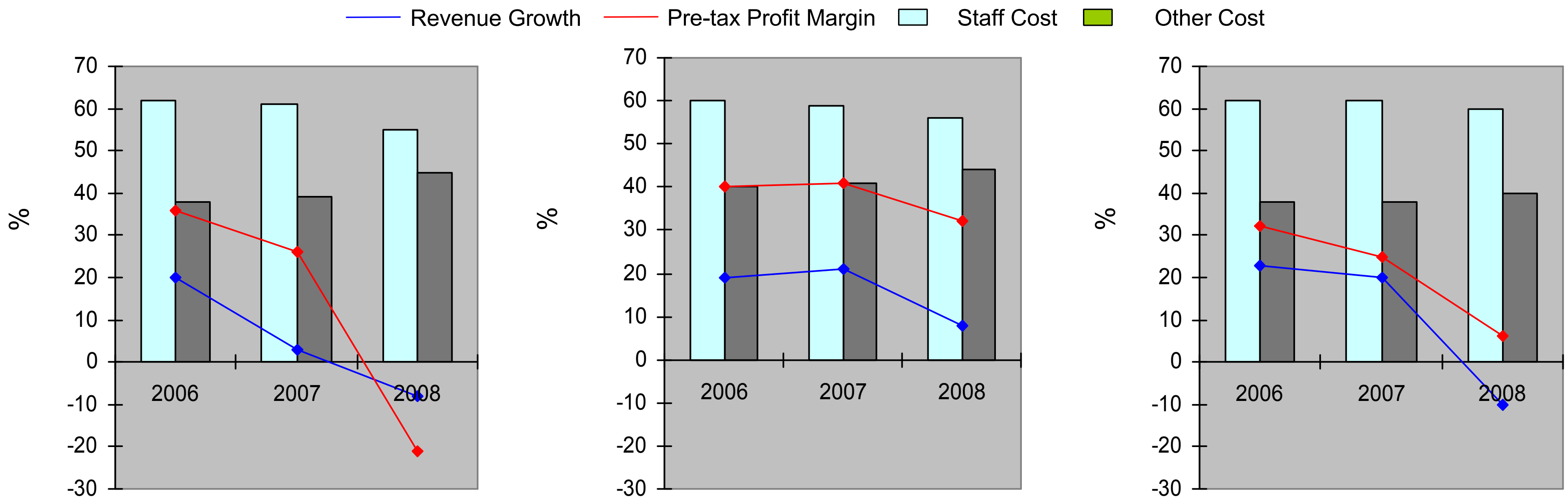
Notes: 1: FI Financial Institutions; 2:IMF 30 Sept 2009 Global Write-down by market (UK valuations covered by Asset Protection Scheme and included in estimate), Source: World Bank', World Economic Outlook 2007-11, IBM Institute for Business Value Analysis, Asia Development Bank, Asia Capital Markets Monitor, citing Bloomberg, April 2009, IMF GFSR, Sept 2009

Banks total cost structure remain high despite their recent decline in revenues

Universal Banks
2006-8

Multinational & National Banks
2006-8

Specialized & Regional Banks
2006-8



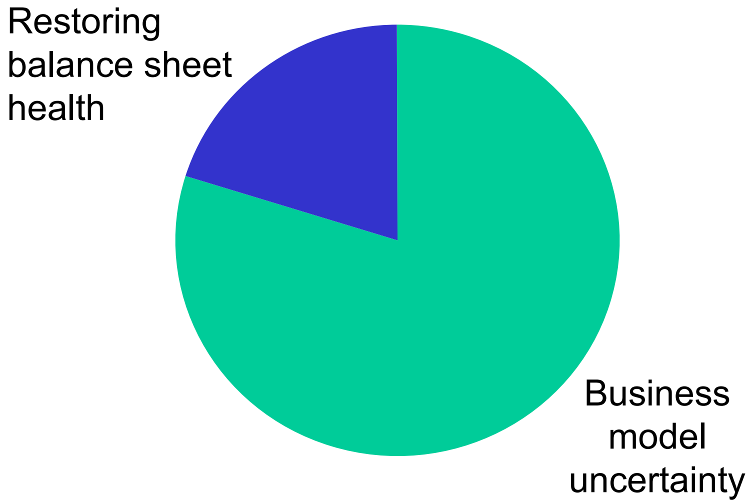
Note: Staff and Other costs are calculated as % of total costs. Total costs = Staff cost + Other cost, where other costs includes general and administrative expenses and do not include Depreciation, amortization, Loan loss Provisions..Source: IBV Analysis, Banks used in calculation are itemized in Appendix

Banks will have to service future growth from radically lower cost structures

Bankers remain uncertain of their business model

What Keeps you Awake at Night[1]?

(Percentage of Executives Interviewed)



n=100

Note: Question asked: (1) What keeps you up at night?;
Source: (1) IBM / EIU survey 2008; IBM Institute for Business Value analysis

Banks must redefine their business models to return to long term health

Business Models

- Strengthening balance sheets is a multi-year journey that requires a combination of raising equity, redefining business models and retaining profits for multiple years
- Reduction in the industry profit pool will require banks to
  - Achieve radically lower costs with reduced complexity
  - Accelerate mergers, acquisitions and divestitures in the banking eco-system

Clients

- Restoring client trust will require banks to gather deeper customer insights **and** craft products and services that are in clients' best interests

Risk

- Radically increased regulatory oversight will require financial institutions to approach compliance with a holistic perspective
- Responsible risk management with a culture of transparency is vital the health of the eco-system

Redefined business models, greater customer focus and superior risk management will separate the winners from the rest

Specialization remains a winning theme

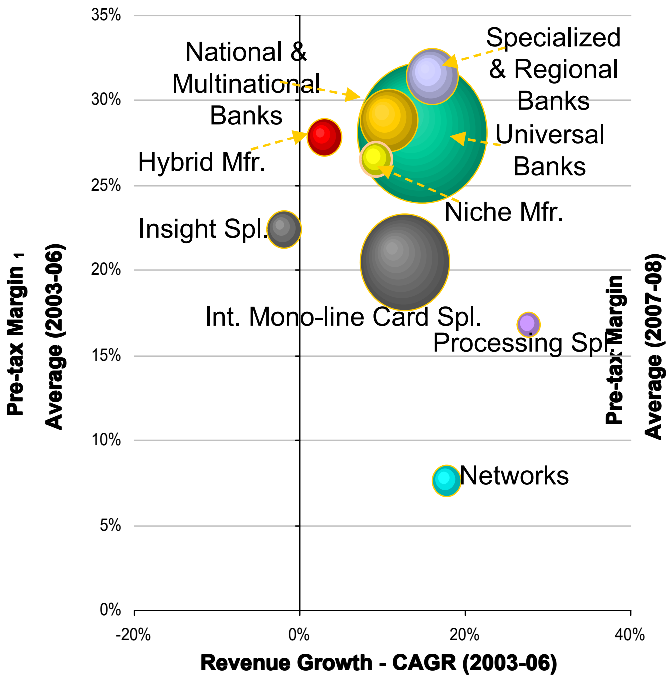
Traditional Banking	Risk & Capital Market Specialists[1]	Customer Intimacy	Operational Excellence
• Revenues **+ 9%** CAGR 2003-08 • Pre-tax profits **- 9%** CAGR 2003-08 • Universal banks: Profits **- 194%** • Government has facilitated mergers of major banks and have funded many others to maintain solvency	• Capital market firms have become banks and are now supervised by the bank regulator • Many US and Europe based risk (mortgage) specialists have been nationalized	• Revenues **+ 10%** CAGR 2003-08 • Pre-tax profits **- 1%** CAGR 2003-08	• Revenues **+ 13%** CAGR 2003-08 • Pre-tax profits **+ 12%** CAGR 2003-08

- Specialists firms in the Customer Intimacy and Operational Excellence domains continue to succeed, thanks to their insights (specialization)
- Opaque products and disconnects with the client have resulted in failures and nationalization of many risk specialists[2]
- Traditional banking and capital market domains are witness to loss of capitalization, and government intervention to provide liquidity

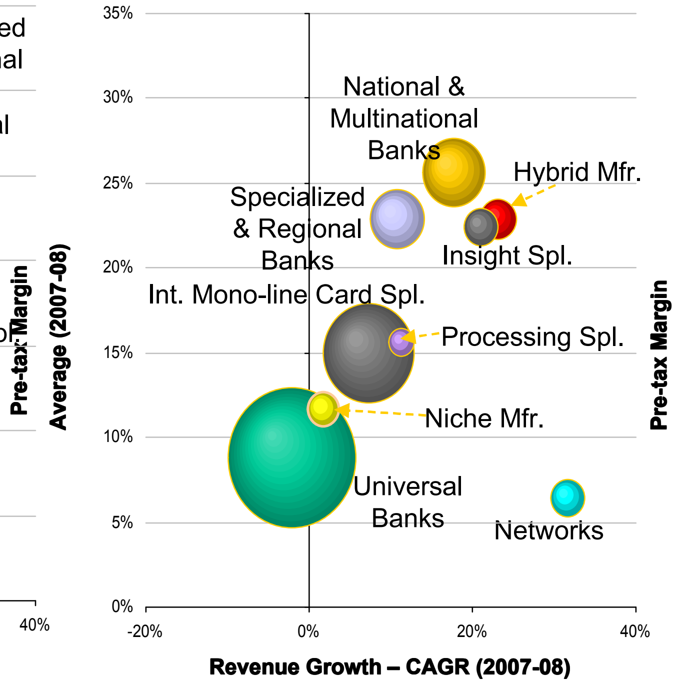
Note: 1,2: Risk & Capital Management is discussed in "Toward Transparency and Stability: A New Financial order" IBM IBV paper. Q2 2009

Profit pools within the eco-system are shifting with the Universals losing most ground

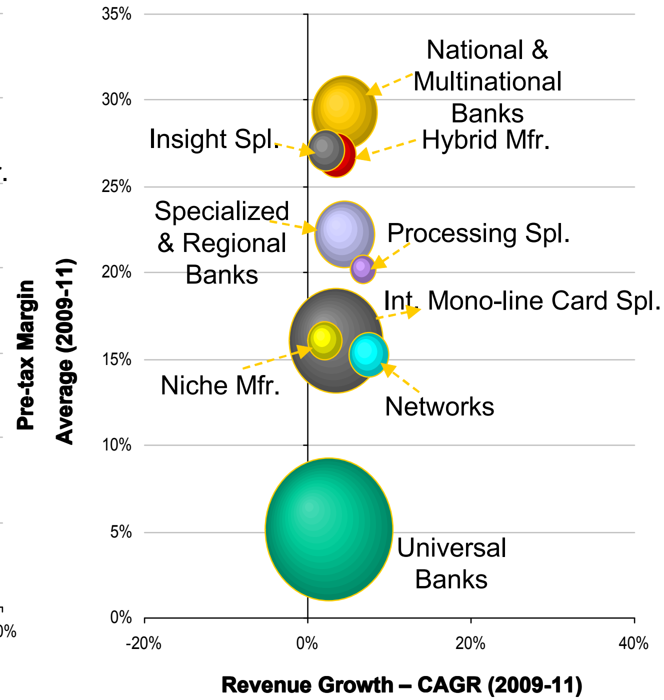
Pre-tax Margin vs. Revenue Growth
2003-6



Pre-tax Margin vs. Revenue Growth
2007-8



Pre-tax Margin vs. Revenue Growth
2009-11E²



Notes Size of ball reflects revenue. 1: Pre-tax margin calculated as ((Pre-tax Profit) / (Net Interest Income + Non Interest Income)); Revenue assumed to grow at a rate of 0% for 2009, and 50% of the avg.2003-8 growth rates for 2010 and 2011 respectively, Further, 10% reduction in cost and loan loss provision is assumed between 2009 -11. Insight specialist sample includes the merged entity Thomson Reuters Corporation in 2008,; Source: IBV Analysis; See appendix for list; 3 http://www.swift.com/sibos2009/news/new_normal.page; 3 Sep 09

"Those profits from the past were not real profits[3]"
Franco Passacantando, M.D., Central Banking, Banca d'Italia at Sibos Sept 2009

Business model innovation is essential to respond to specialists – who are eroding banks' customer base

Specialists are delivering increasing customer value through innovation

Service
(Peer-to-Peer Lenders)

- **Approach**: Provide 24X7 community forums for making person to person, small business and real estate loans, offsetting risk and providing access to the underbanked.
- **Impact**:
  - Peer-to-peer lending sites claim over 500,000 members and $300mm in loans
  - Growing use of Internet tools and delivery among the world's 7.000 micro lenders and 16mm micro borrowers

Delivery
(Mobile Payment Providers)

- **Approach**: Enable use of available infrastructure (mobile phones) to transact payments and access banking services. Tapping informal, cash economies with limited infrastructure. Has reduced merchant fees.
- **Impact**:
  - Mobile transactions will total $22B by 2011
  - P2P mobile payments are driving rapid adoption in the developing world
  - Contactless payments, key in mature markets, will be used by 52mm by 2011

Advice
(On-line Communities of Advice)

- **Approach**: Give customers access to web sites that help them manage their finances. Enable knowledge sharing among communities of consumer investors
- **Impact**:
  - 44% of Internet users in US report getting financial advice or information online
  - Unique visitors to finance web sites are growing at about 10% per year

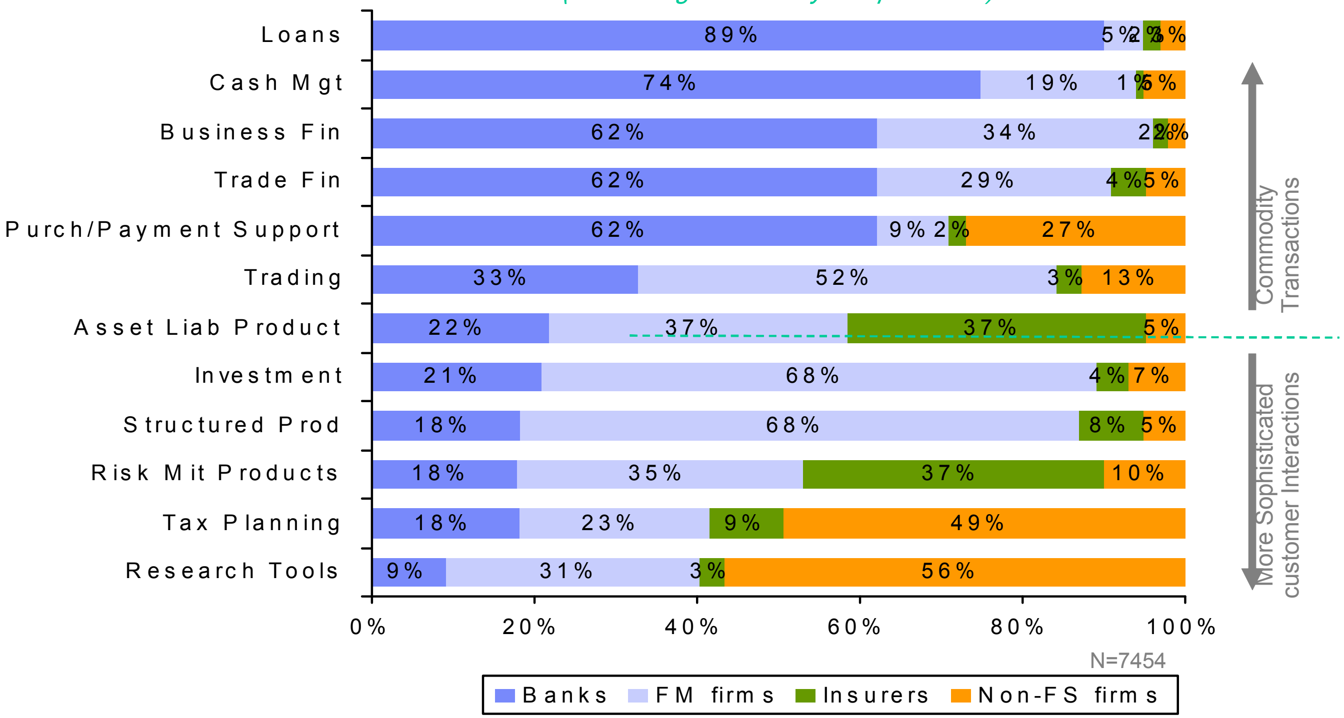
Specialists have been cherry-picking select customer segments – 28% of executives mentioned online and mobile players as potential threats

Source: Company web sites; Grameen Bank; Juniper Research; Pew Trust; comScore Media Metrix; IBV interviews; IBM Institute for Business Value analysis, No Bank is an Island

Customers perceive bank services as commodity and are looking elsewhere for more sophisticated needs

Customers preferences for providers of financial products and services

(Percentage of Survey Respondents)



Note: Question asked: For each product, which type of firm will be best able to meet clients' needs in the future?
Source: IBV/Economist Intelligence Unit Banking Survey 2008; IBM Institute for Business Value analysis

58% of executives believe specialists will outperform large universal banks in better meeting clients needs over the next 3-5 years

ING Direct

ING DIRECT

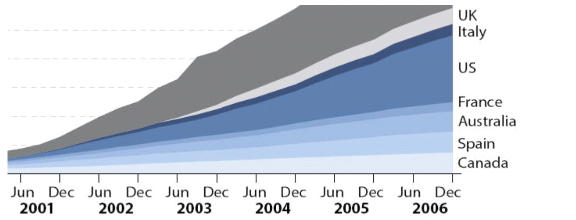
- ING Group established ING Direct in 1997 as a direct banking subsidiary targeting Europe, North America and Australia, offering:
  - A few simple financial products
  - High savings rate
  - Direct distribution exclusively
  - Major marketing spending
- Other banks had embraced direct banking previously, but the ING Direct significantly disrupted major markets by:
  - Clearly differentiating from competitors by offering a simple, compelling proposition
  - Marking locally, within a common global message
  - Providing simple design, and flexible, reusable operational architecture
- By 2008, ING Direct had 21.5 million customers globally, including 6.5 million in the US[1]
- Since 2005, ING has experienced more intensive competition from HSBC, Citi and others, but remains a formidable competitor
- Late 2007, ING Direct USA acquired ShareBuilder (7th largest US online broker), with a view to expanding its offering, and disrupting further

"I'm actually surprised it took five years [for Citi and HSBC to enter the direct banking space] … we don't worry about having a number of competitors. I think they have a real handicap – in that they are big traditional banking institutions"

Arkadi Kuhlmann, ING Direct, CEO[3]

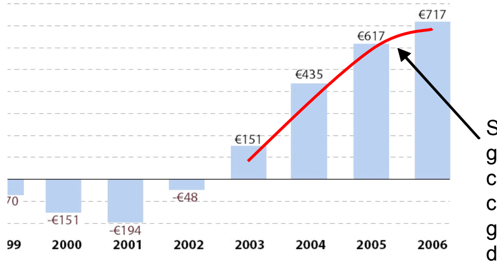
ING Direct Number of Direct Accounts [2]

Stable account growth



Source: Forrester Research, Inc.

ING Direct Annual Pre-tax Profit [2]



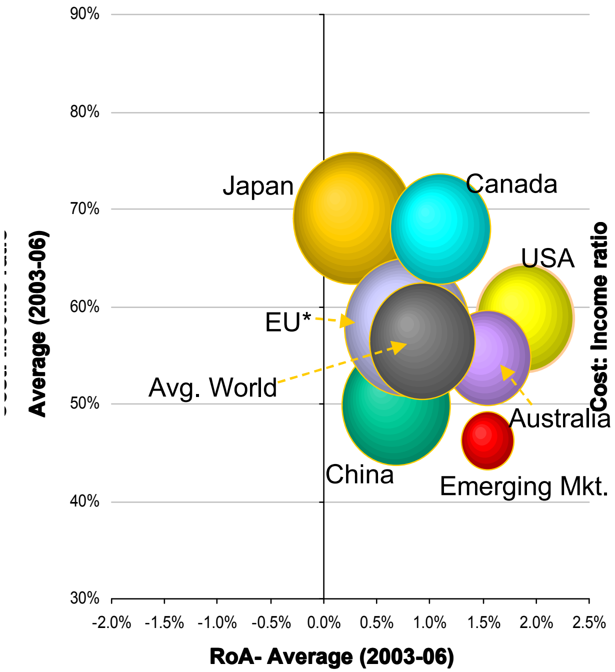
Slowing profit growth reflects closing of competitive gap after initial disruption

Source: Forrester Research, Inc.

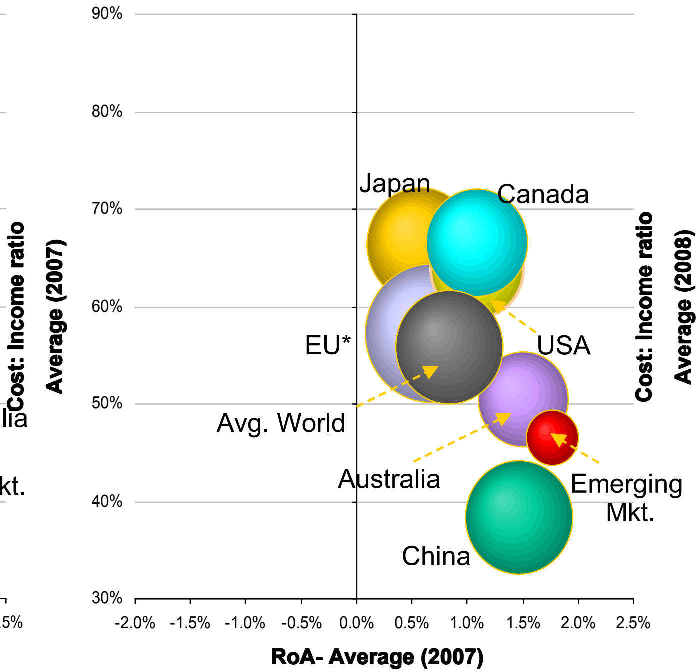
[1] http://home.ingdirect.com/about/about.asp, May 2008; [2] Forrester, The Sources of ING Direct's Success (2007), ING Infiltrates the Brokerage Market with ShareBuilder (2008); IBM analysis [3] http://www.paymentsnews.com/2006/04/ing_direct_ceo_.html

Banks in emerging markets, unlike banks in mature markets, have *improved their cost structure* over the last two years

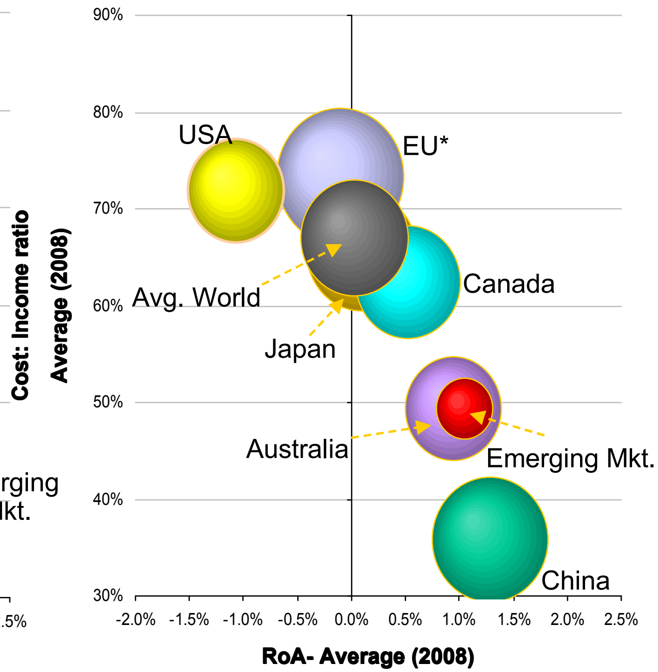
Cost: Income ratio vs. RoA
2003-6



Cost: Income ratio vs. RoA
2007



Cost: Income ratio vs. RoA
2008



Notes: Cost is defined as operating expenses, including depreciation but without provisions; Income ass the sum of net interest income and non-interest income. Return on assets is calculated as: (Pre-tax Profit) / (Total Assets). Size of bubble represents average size of assets. EU* = European Union, Norway, Switzerland and Turkey; Emerging Markets include Asia (excluding Japan & China), Brazil, Russia and South Africa. n= The Top 200 banks as ranked by thebanker.com on the basis of Tier 1 Capital.
Source: thebanker.com, IBV Analysis

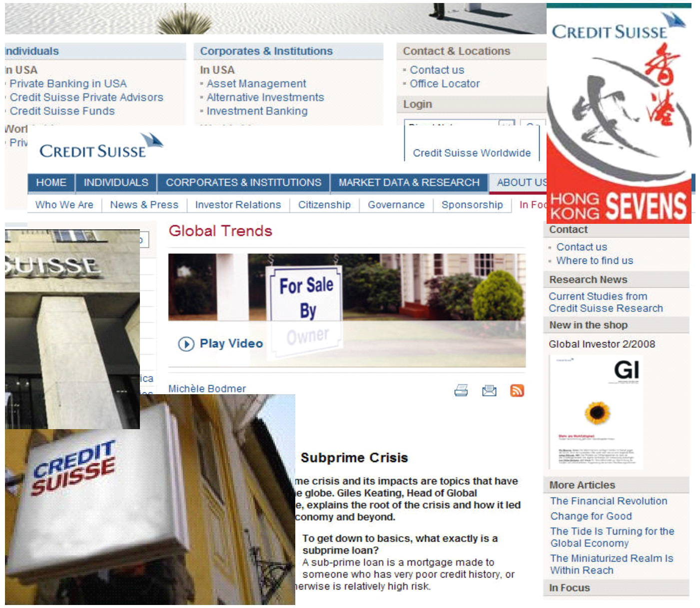
Credit Suisse and "One Bank"

CREDIT SUISSE

- In April 2005, Credit Suisse announced its One Bank initiative by merging the Credit Suisse private and retail bank, and CSFB investment bank and asset management functions[1]
- Credit Suisse also decided to strategically expand its Asian operations in Singapore, HK, China and elsewhere[2]
- IT, HR and other functions are now managed globally, with specific activities and functions sourced from Centers of Excellence in Pune, India and elsewhere
- Despite current problems with a slowing global economy and problems sub-prime exposure experienced by some key competitors, Credit Suisse remains committed to the One Bank concept and the efficiencies and benefits it is expected to deliver[4,5]
- Centralization of some processes also support efforts underway to normalize cultures across geographies and LOBs

"Our strategy of a globally positioned and integrated bank, combining investment banking, private banking and asset management, is working well even in difficult market conditions"

Walter Kielholz, Credit Suisse, Chairman[6]



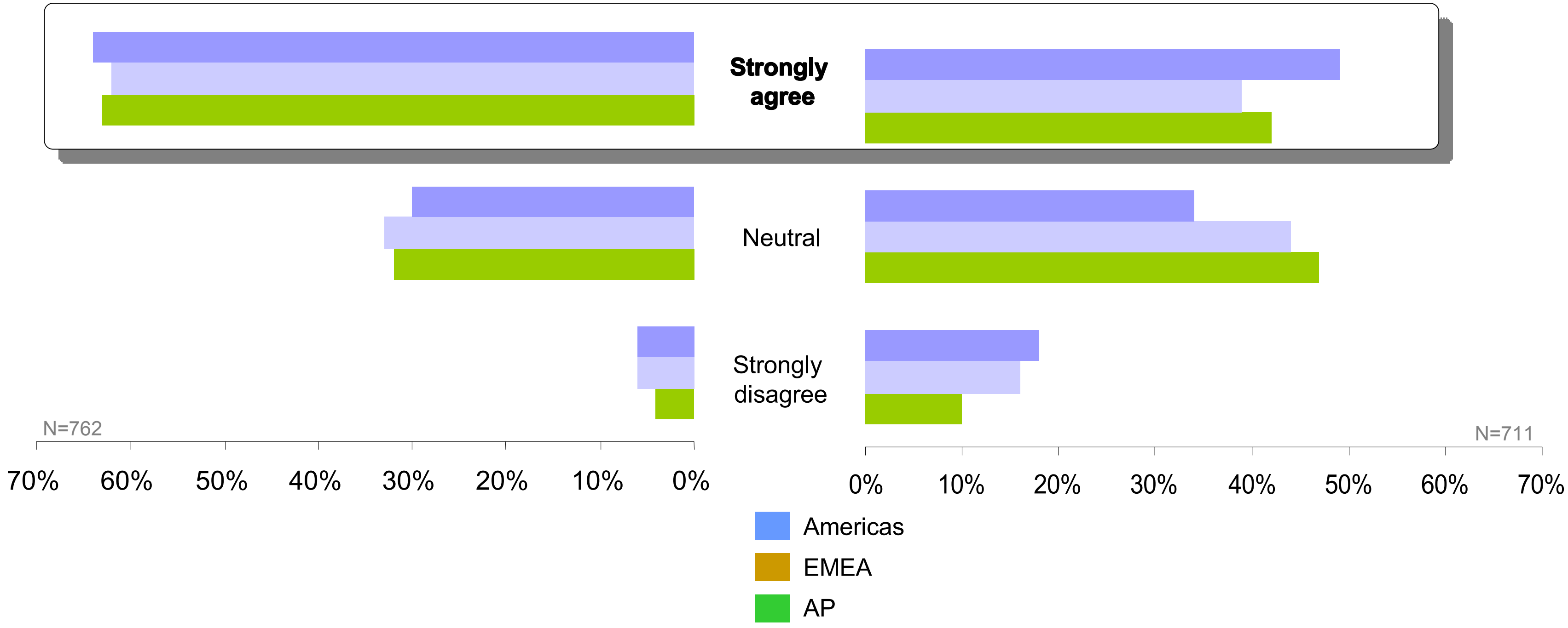
[1] Credit Suisse Group to Merge Banking Units, April 2005, http://www.credit-suisse.com/news/en/media_release.jsp?ns=38565; [2] Professional Wealth Management, March 2005, Credit Suisse promises to show just 'one face' to clients, http://www.pwmnet.com/news/fullstory.php/aid/1114/Credit_Suisse_promises_to_show_just_%91one_face%92_to_clients.html; 3 ;The Financial Express, March 2007, Credit Suisse plans for centre of excellence in Pune, http://www.financialexpress.com/news/Credit-Suisse-plans-for-centre-of-excellence-in-Pune/193626/; [4] The Economist, April 2008, The higher they climb; [5] Reuters, January 2008, Credit Suisse chairman defends integrated bank model, http://uk.reuters.com/article/governmentFilingsNews/idUKL2470820220080124?pageNumber=1&virtualBrandChannel=0 [6] http://uk.reuters.com/article/governmentFilingsNews/idUKL2470820220080124

Banks need to overcome the trust gap with their client as they move beyond today's crisis

Trust Gap

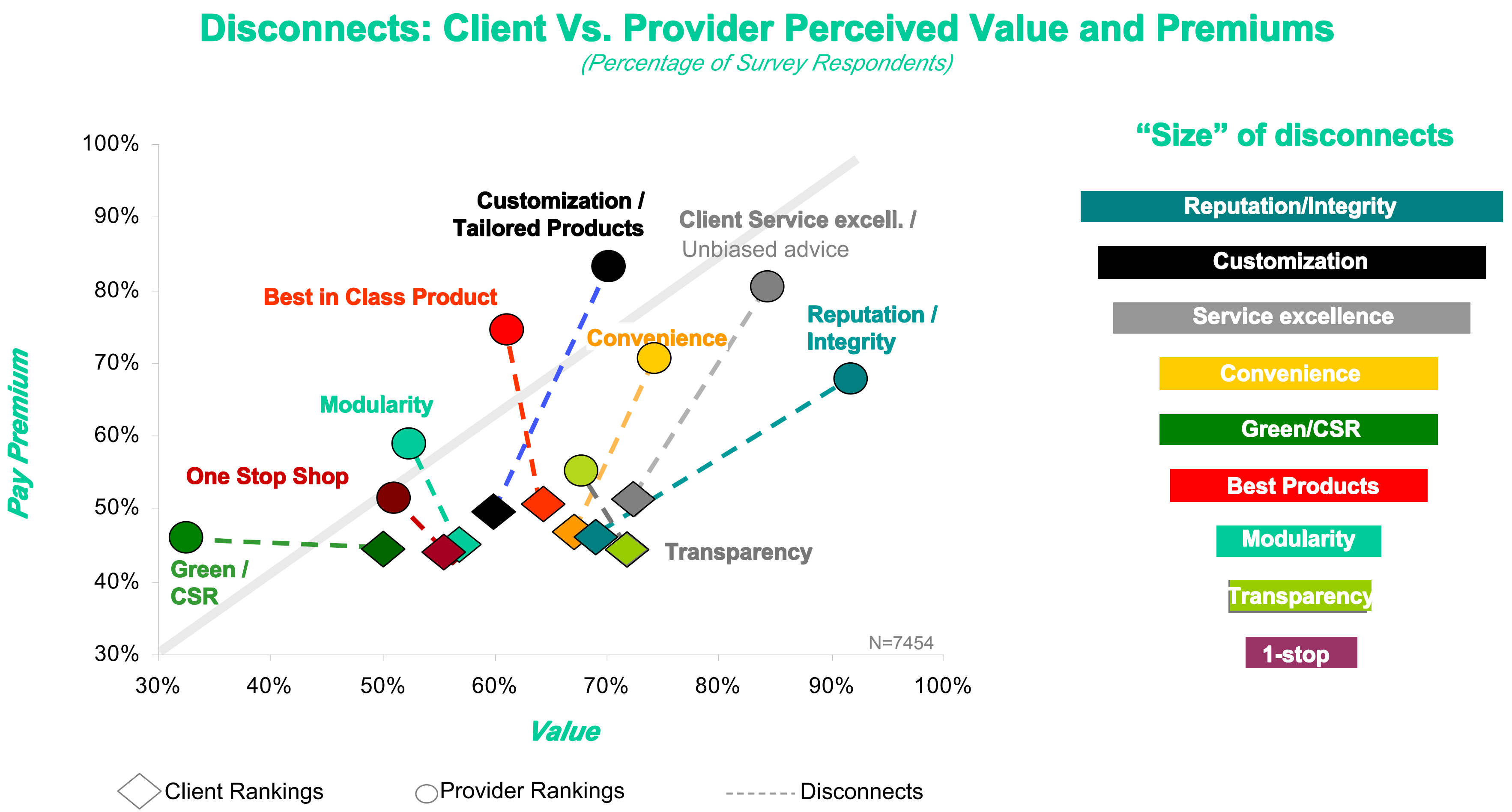
Client Opinion: Providers offer products in the firm's best interest
(Percentage of Survey Respondents[1])

Provider Opinion: Providers offer products in the firm's best interest
(Percentage of Survey Respondents[1])



Note: Question asked: To what extent do you agree / disagree with the following statements about trust, Please rank on a scale of 1-6 where 1=strongly disagree and 6=strongly agree, Investment firms are likely to offer products & services in the investment firm's own best interest. Source: IBV / CFA Survey 2008; IBM Institute for Business Value analysis

Banks have overlooked customers' values and behaviors

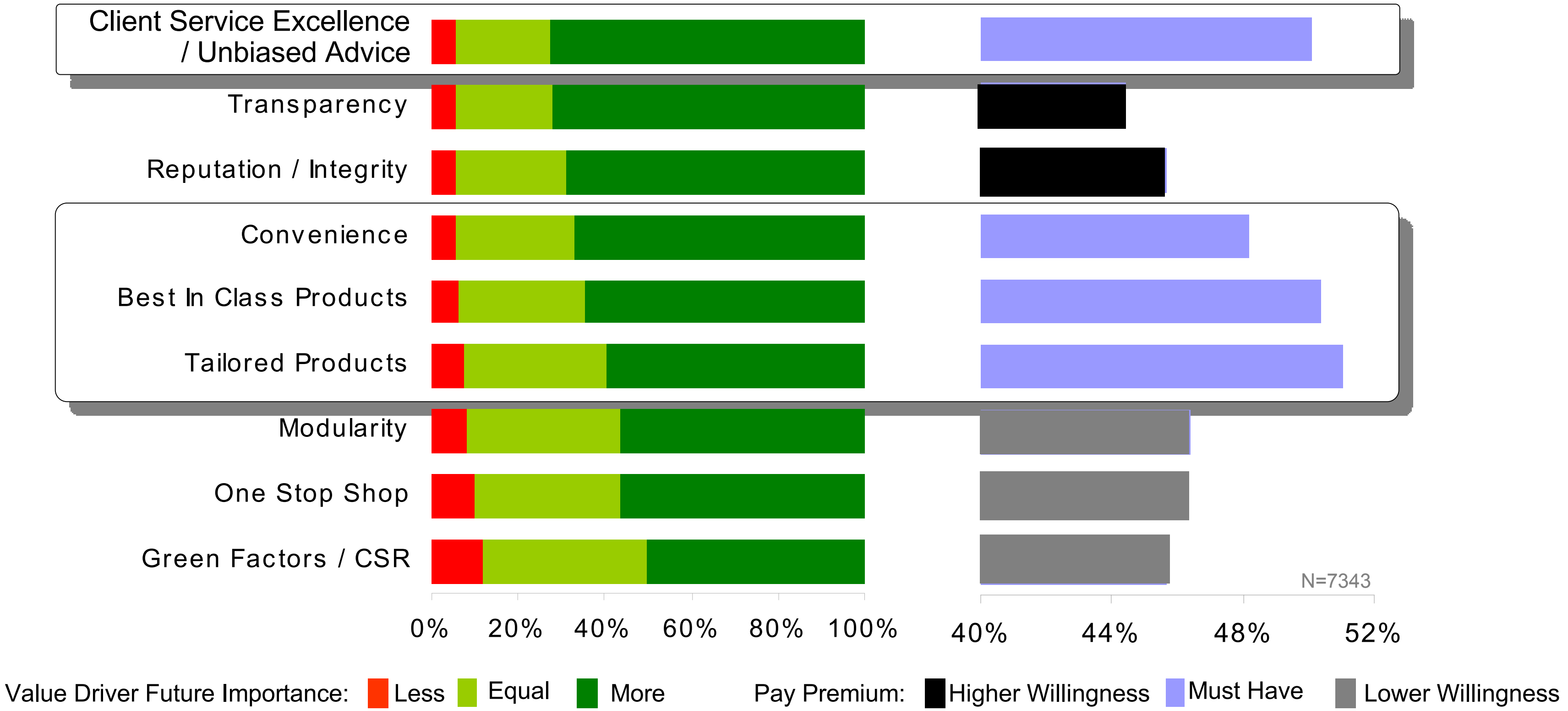


Note: Question asked: Which financial services capabilities become more/less important to you in the next 3-5 years? Rank 1-6. How much would your clients be willing to pay over existing rates to ensure that you deliver on specific factors, Select 0%, 5%, 10%, 15% or more, don't know.
IBV/Economist Intelligence Unit Banking Survey 2008; IBM Institute for Business Value analysis

Banks must understand what clients actually value and what clients are *willing* to pay

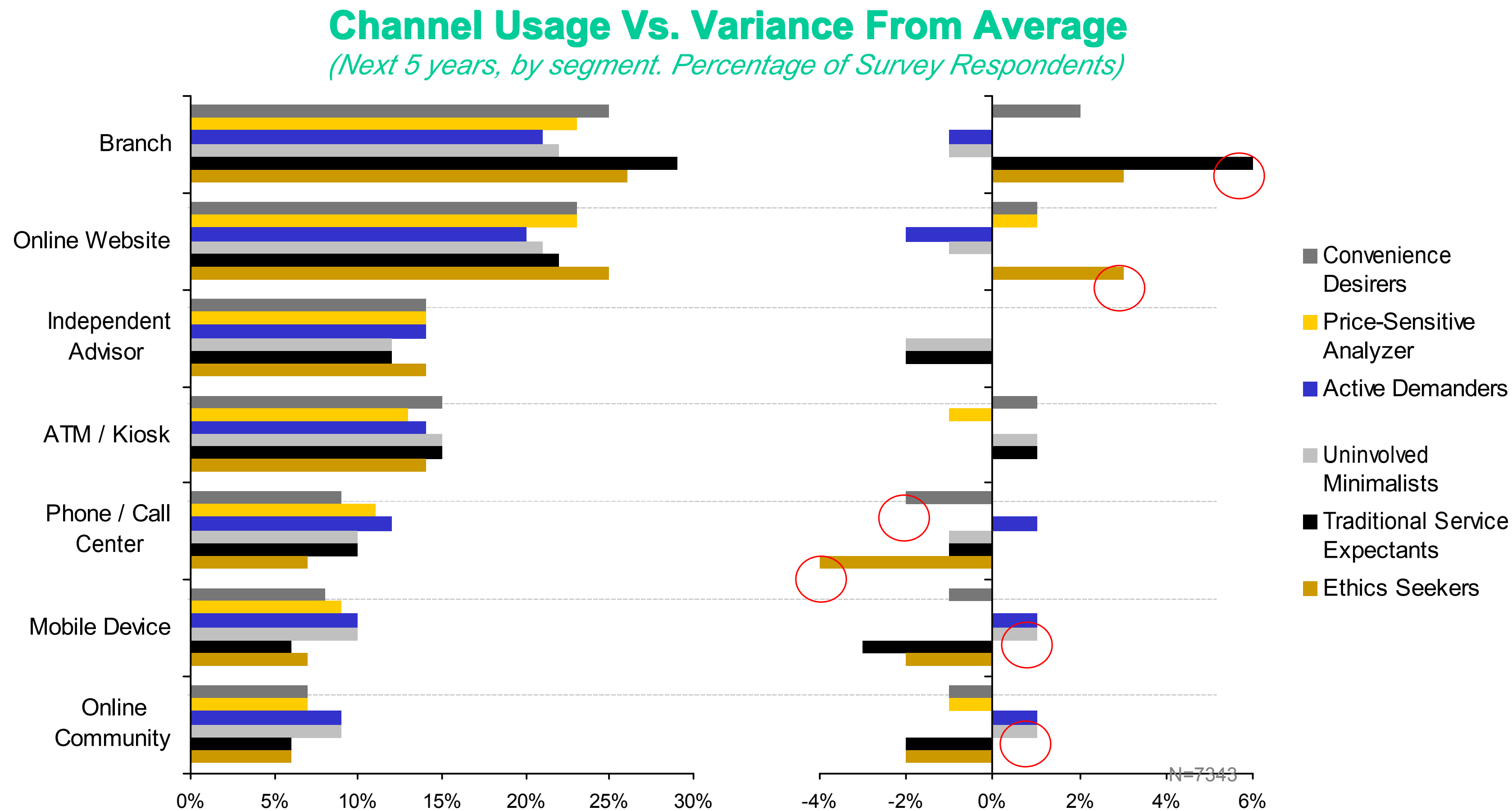
Clients Indicated Future Value Drivers vs. Pay For Premiums

(Percentage of Survey Respondents)



Note: Question asked: Will financial services capabilities become more/less important to you in the next 3-5 years? Rank 1-6. How much would your clients be willing to pay over existing rates to ensure that you deliver on specific factors, Select 0%, 5%, 10%, 15% or more, don't know. IBM Institute for Business Value Banking Survey 2008, IBM Institute for Business Value analysis

… and by their choice of channels when interacting with banks



Note: Question asked: What will be your preferred channels for buying financial services over the next 5 years? Scale of 1-6 where 1=Not important and 6=Very important. Source: IBM Institute for Business Value Banking Survey 2008

In Summary

Which forces will disrupt the industry landscape?

- New regulatory requirements and policies
- Mergers and divestitures in the ecosystem will accelerate
- New capital and leverage requirements will increase the focus on banks' balance sheets

What will clients pay for?

- Clients value excellent service and unbiased advice from their service providers. The clients' willingness to pay varies by nature of the client segment and by country

How will the bases for competition change?

- Specialization remains a winning strategy
- A culture of risk and risk based decision making
- Banks will simplify their business models (and costs) to compete

What steps must firms take today to win?

- Revitalize the balance sheet
- Rebuild customer intimacy
- Rethink the business model
- Holistic risk and compliance management
- Refresh processes to eliminate complexity
- Restore shareholder value
- Reform culture for making risk based decisions
- Recast analytics for CRM, risk and intelligence

Become a Smarter Bank

Agenda

- Fit Focused and Ready to Fight – How banks can get ready for the challenges ahead

- Smarter Banking – Software Frameworks enabling banks to meet the challenges

Reasons to be optimistic
There is an extraordinary opportunity !

5.8% CAGR

Growth in world GDP[1] from 2010 thru 2025 will put the current crisis in context.

2.5 billion

Half the world is unbanked. Just over half of world's adult population do not use formal financial services to save or borrow.[2]

$1,264 trillion

The value of global assets[3] will quadruple by 2025 – calling on a vibrant global financial system to intermediate and manage.

1 - Nominal
2 - http://financialaccess.org/sites/default/files/110109%20HalfUnbanked_0.pdf
3 - Assets = deposits, equity and fixed income

Growth requires smart institutions to think and act in new ways

Rethink the business model

Drive a simplified and streamlined agile enterprise that balances growth, efficiency and business resiliency

Develop new intelligence

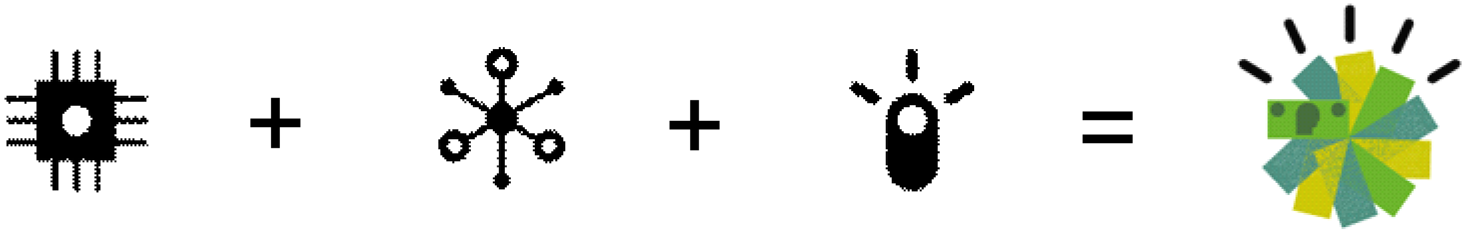
Develop enterprise wide capabilities to enable informed judgment, client-centricity and profitable growth

Integrate risk management

Achieve compliance objectives while mitigating operational risk, fighting crime and optimizing financial returns

Smarter banking solutions have a common set of attributes

INSTRUMENTED INTERCONNECTED INTELLIGENT SMARTER BANKING



INSTRUMENTED

Financial products are decomposed and managed at the atomic level, allowing the participants to measure, control, sense and respond quickly and precisely based on a "single source of truth."

INTERCONNECTED

A smart bank is built on systems that advance processing to better automate transactions with counterparties, partners and suppliers to enable innovation across the value chain.

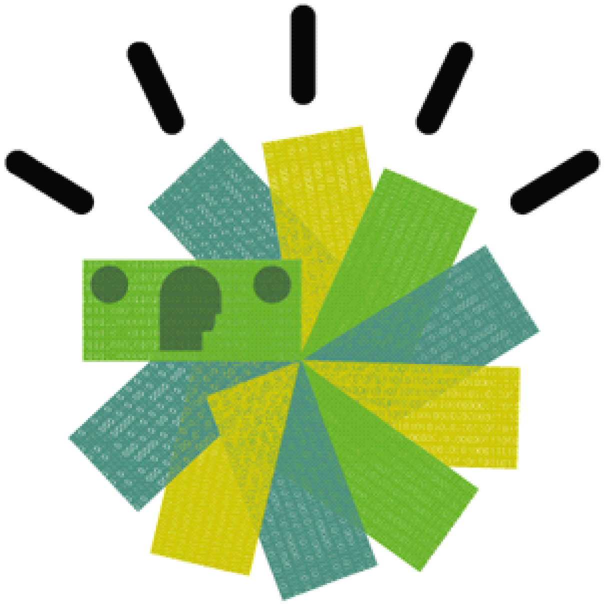
INTELLIGENT

A smart bank enables the rapid, intelligent analysis of a vast mix of structured and unstructured data to improve insight, enable informed judgment and fight abuse.

SMARTER BANKING

A smart bank anticipates client needs and delivers innovative products more quickly and consistently than the competition. It can respond nimbly to changes in market conditions.

Intelligent software is critical to enabling smarter banking



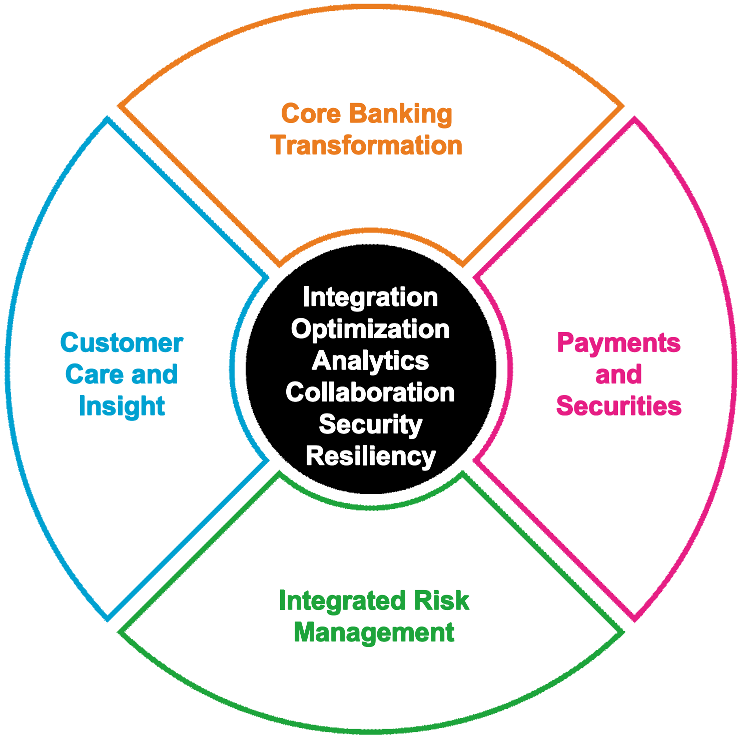
Software is helping banks:

- Consume exploding volumes of data
- Achieve an information advantage
- Drive on-going product innovation
- Serve new global markets
- Deliver a more energy efficient world

Software is increasingly viewed as a strategic business asset:

- Leaders are deploying intelligent software, systems and products
- Success depends on the ability to accelerate innovation and enable change by managing software delivery effectively

IBM provides a comprehensive framework that delivers accelerates solution deployment



The framework gives you speed, flexibility and choice in deploying solutions while reducing cost and risk!

The framework provides a banking-specific software platform with…

- Banking extensions and pre-built solution accelerators to speed deployment
- Best practices and business-specific usage patterns to lower risk
- Support for adoption of open and industry standards
- A choice of business applications from IBM business partners
- An approach to align technology with business needs

धन्यवाद
Hindi

Gracias
Spanish

תודה רבה
Hebrew

Спасибо
Russian

Grazie
Italian

Thank You
English

Obrigado
Portuguese

شكرا
Arabic

Gary McBride
gmcb@us.ibm.com

Merci
French

多謝
Traditional Chinese

Danke
German

Terima kasih
Bahasa

நன்றி
Tamil

ขอบคุณ
Thai

多谢
Simplified Chinese

ありがとうございました
Japanese

감사합니다
Korean

Salamat
Tagalog

IBM's banking study draws on surveys of 100s of individuals, businesses and on secondary research to determine how firms will compete for the future

- **Which forces will disrupt the industry landscape?**
- **What will clients pay for?**
- **How will the bases for competition change?**
- **What steps must firms take today to win?**

IBM Institute for Business Value

Economist Intelligence Unit

The Economist

Scope

- Our analysis focused on gaining insights from select financial institutions including:
  - Traditional banks (Universal banks, National and Multinational banks, Regional banks, Specialized banks, Savings & Loans / Cooperative banks and building societies)
  - Specialist and boutique banks
  - Regulators / government officials
  - Operational specialists, service providers,
  - Others: non-governmental organizations, academics

Approach

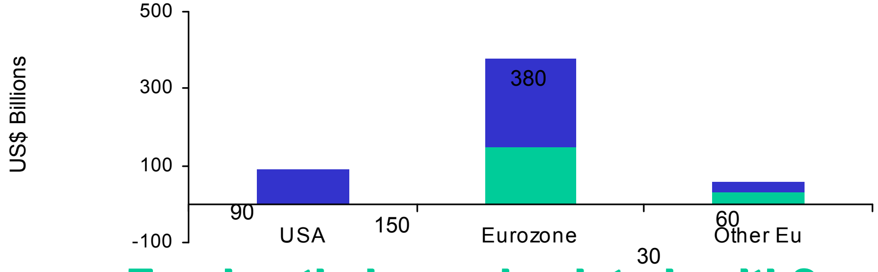
- The IBV Financial Services studies surveyed 7,343 consumers and 2,569 business leaders from 500 firms[2]:
  - Qualitative interviews of 100 executives
  - Survey of 2,569 executives, in partnership with the CFA Institute and the Economist Intelligence Unit
- We conducted secondary research and developed quantitative models of 139 financial institutions
  - Top 117 of the Top 200 banks by assets (Top 79 of the Top 100)
  - 34% Americas, 36% Europe and 30% Asia and Australia

Note: [1]Primary research was conducted from November 2008 through December 2008, [2]85% of business leaders are Board or C-level, EVP or divisional head with the remainder Director, SVP or VP level; [3]EMEA is Europe, Middle East, Africa

Strengthening the balance sheet: raising capital, increasing asset quality and profits – a multi-year exercise

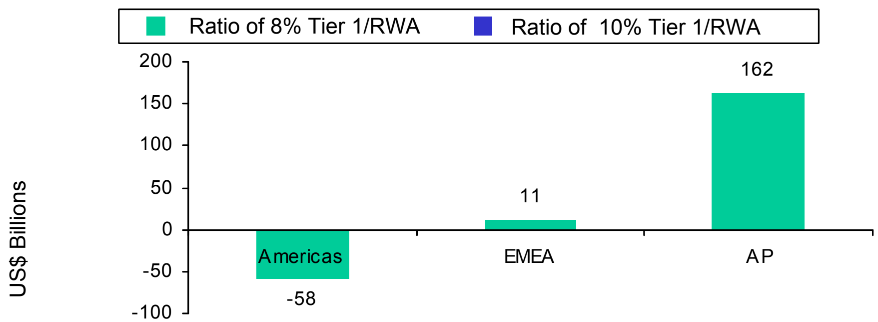
Capital Needed for Target Ratio

Capital needed by 2010 Q4



Earning their way back to health?

Net Profits 2008



New Basel Rules Will Constrain Profits

Capital Rules effective Y/E 2010

- ~2* times capital against the trading book
- ~3* times capital against securitized products

Proposals being reviewed/ finalized

Sec'y Tim Geithner's proposals: **"New capital rules by 2010"** and **"in force two years later"** Sept 4 2009

Banks would **"be required to hold more and better quality capital** once recovery is assured"

Sept 5 2009, G20 Finance Ministers Final Statement, London

Notes: IMF financial stability scenarios: 1. GFSR deleveraging scenario, 2. approx. leverage of USA banks in mid-1990s . Sources: IMF Global Financial Stability Report Sep 2009; IBM Institute for Business Values analysis, Reuters. www Reuters.com "Banks eye clock on tougher capital rues", Sept 8 2009, http://www.guardian.co.uk/business/feedarticle/8696439, Banker, Top 1000 World Banks, July 2009

For many banks, outside the emerging markets, a return to historic profit levels is possible only through a combination of cost cutting and business model innovation

Assuming no revenue growth through 2009, banks will have to reduce costs in order to improve their profit margins

	Average Pre-tax Profit Margin (2003-06)	Pre-tax Profit Margin (2007)	Pre-tax Profit Margin (2008)	Staff Costs & Administrative costs as % Total Income (2008)	Reduction in Costs over 2008 required to reach historic (2003-6) profit margins in one year		
							Emerging Nations
Universal Banks*	35%	26%	-21%	67%			NA
Multinational & National Banks	38%	41%	32%	43%			
Specialized & Regional Banks	30%	25%	6%	64%			

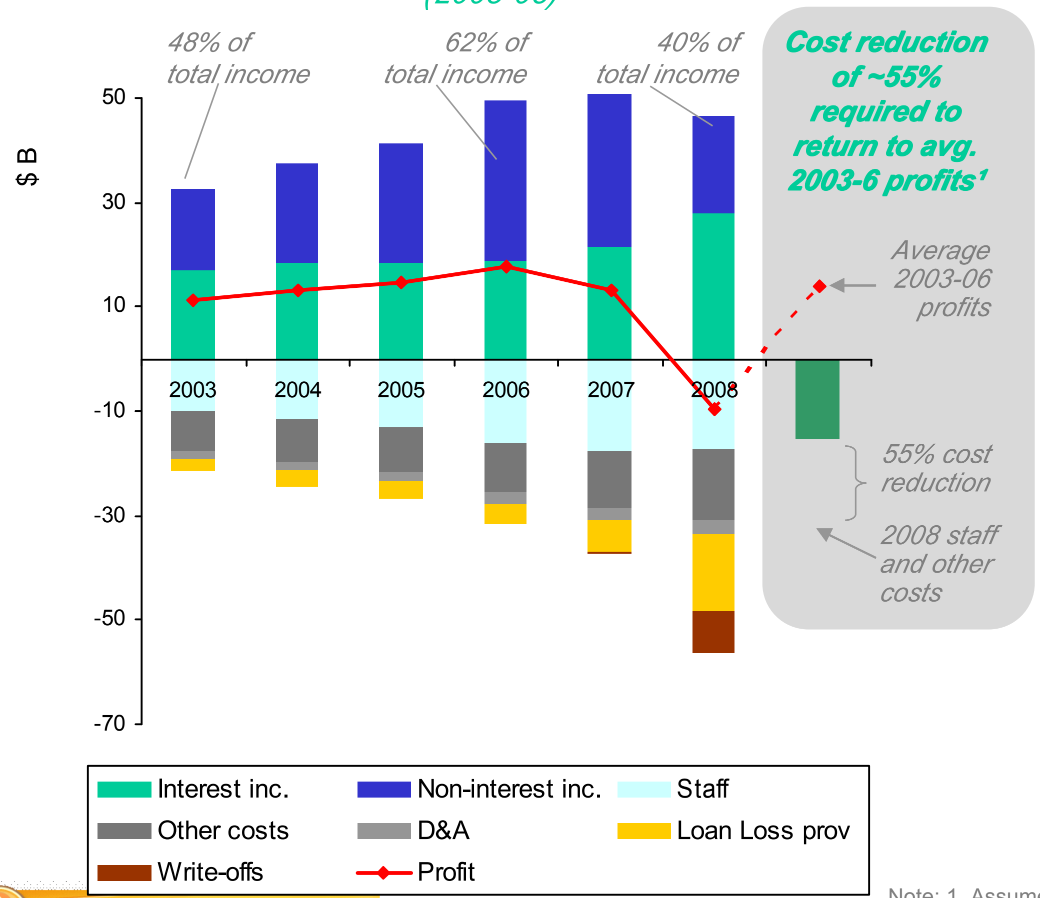
Note: Revenue growth is assumed to be 0% in 2009. For projection, depreciation & amortization and loan loss provisions are assumed to remain at 2008 levels where as, one-off costs are assumed to be zero;. Source: IBV Analysis Profit Map Model, 2009; Banks used in calculation are itemized in Appendix

To return to historical levels of profitability Universal banks will have to cut costs by 40-55% (high) Emerging market banks can return to profits through growth

Universal banks must focus on new business models to recover lost ground

Universal Banks Aggregated Income Statements

(2003-08)



- Universals banks have been reducing capacity
  - Staff costs reduced slightly in 2008 (1.7%)
- They cannot return to historical levels of profitability by cutting costs alone
  - Revenues are likely to remain flat and loan losses high in the short term
  - Operational costs reduction of ~55% required to return to average 2003-06 profits (assuming loan loss provisions remain at 2008 levels)
  - Operational costs reduction of ~17% (if loan loss provisions return to average 2003-06 levels)
- They will need to address the business model and seek sustainable revenue growth

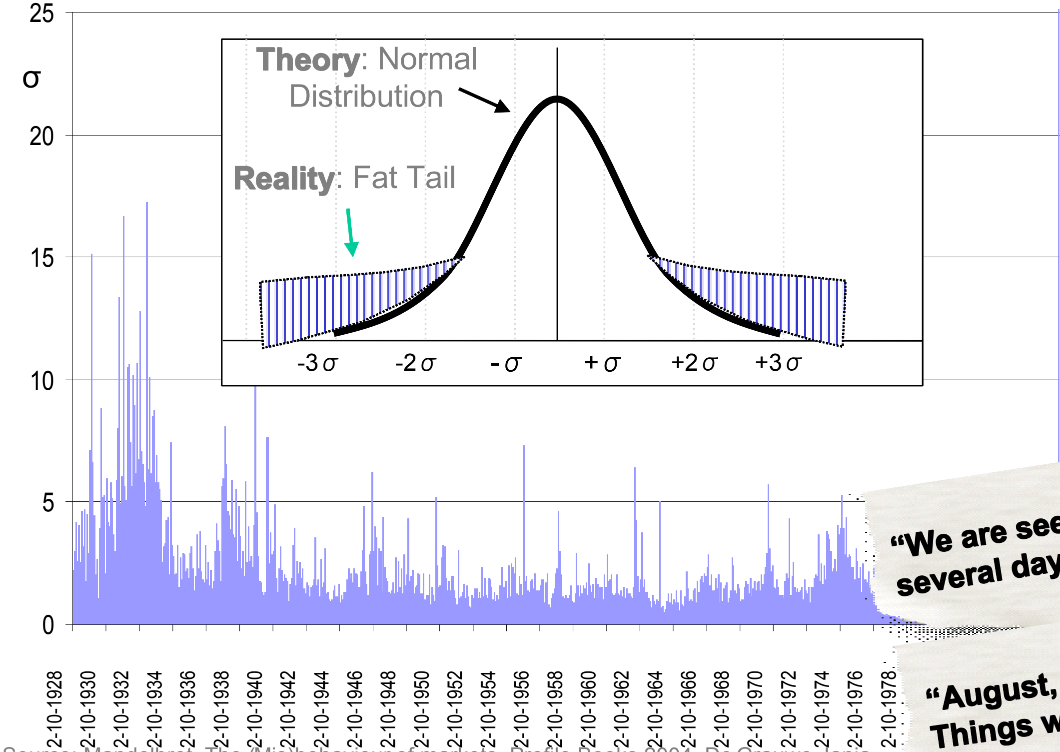
Universal banks need to <u>combine</u> cost cutting with business model innovation

Note: 1. Assumes no write-offs and D&A, loan loss provisions and revenues remain constant.
Source: IBV analysis: Banks used in calculation are itemized in Appendix

Traditional models underestimate risk and do not account for the frequent occurrence of extreme events

Daily movements on the Dow Jones Index

(Number of standard deviations (σ), October 1928-August 2009)



Theory:
5σ occurs not more than once in 7000 years

Reality:
> 5σ occurs 73 times in last 80 years

Theory: > 10σ occurs once in 73x10[21] years.

Our universe: 20 billion years old. So that is a wait time of another trillion universes to see it again.

Reality: occurs twice in Oct. 2008

"We are seeing things…25 standard deviation moves several days in a row"….Aug 13 2007, Financial Times[1]

"August, Year of the Lord 2007 was a very special month. Things were happening that were only supposed to happen once in every 100,000 years. …….or our models were wrong[1]

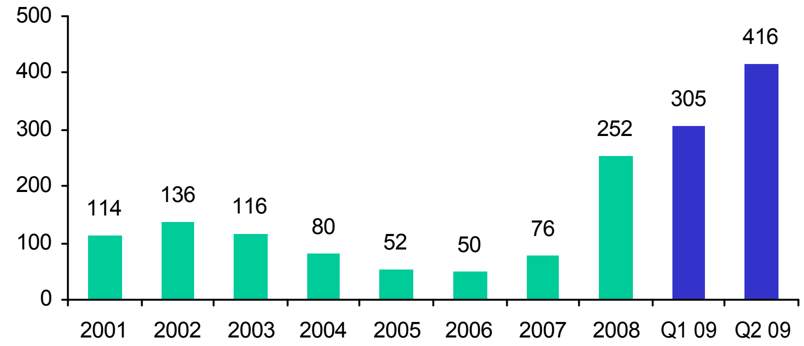
Source: Mandelbrot, The (Mis)behaviour of markets, Profile Books 2004, De Grauwe, Iania, Kaltwasser, How abnormal was the stock market in October 2008?, 11th Nov 2008, http://www.eurointelligence.com/article.581+M5f21b8d26a3.0.html IBM Institute for Business Value analysis; [1] How unlucky is 25 Sigma?", Banking & Financa, UCD Schools, University of Dublin, www.ft.com

Banks struggling to cope with the combination of the economic recession, increasing risks and greater compliance burdens

Financial Risk	**80%** of firms don't have integrated risk processes[1] **300%** rise in FDIC bank closures
Financial Crimes	**Millions** of electronic attacks, yearly, focused on the finance sector[2]
Operational Risk	**Billions** of market trades each day: global trading systems are under extreme stress with limited insight into the risk assumed[3]
Governance, Compliance	**Thousands of** regulations worldwide; **Hundreds** more being added.[4]

FDIC-insured "Problem Institutions"

(Number of institutions, 2001-2009)



Toxic Assets in the System

- Governments worldwide have spent more than **$10T** to rescue the financial sector
- IMF has estimated the global toxic assets to be **~$3T**[5]

Source: : 1 Governance, risk and compliance in financial services, The Economist June 2008, IBM CRO Survey; 2 IBV analysis; 3"The Smarter Financial Services Industry: Forging a path to smarter financial services growth, stability and resiliency", 4 IBM "Navigating the Compliance Labyrinth: The Challenge for Banks 2007" (Deloitte) , IBM Forecast; 5. IMF GFSR Sept 2009