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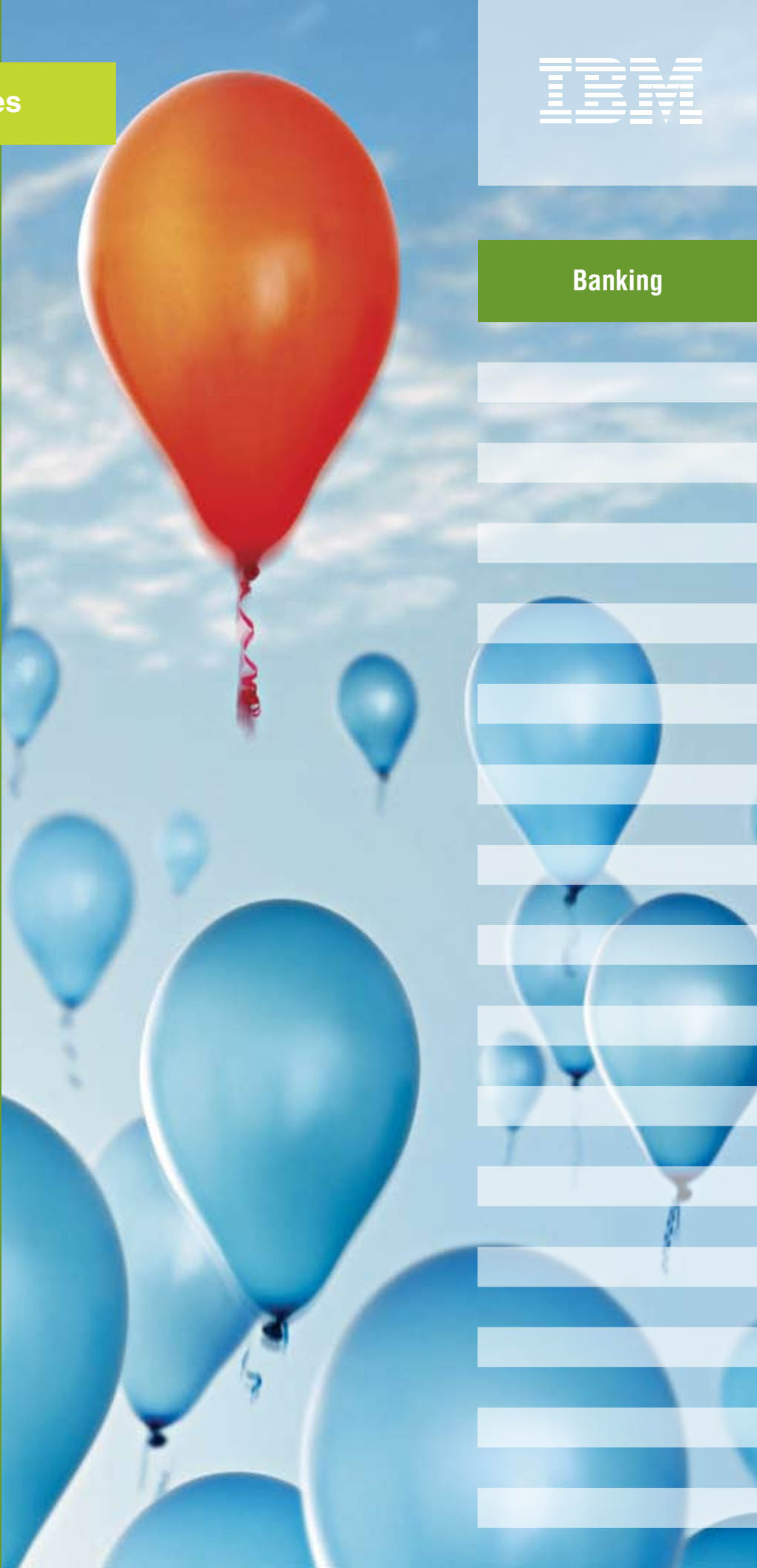
*IBM Institute for Business Value*

# Dare to be different

Why banking innovation matters now

IBM

Banking



## **IBM Institute for Business Value**

IBM Global Business Services, through the IBM Institute for Business Value, develops fact-based strategic insights for senior business executives around critical industry-specific and cross-industry issues. This executive brief is based on an in-depth study by the Institute's research team. It is part of an ongoing commitment by IBM Global Business Services to provide analysis and viewpoints that help companies realize business value. You may contact the authors or send an e-mail to [iibv@us.ibm.com](mailto:iibv@us.ibm.com) for more information.



# Dare to be different

## Why banking innovation matters now

*Retail banks can't assume that the growth and returns of the recent past will continue. Amid a throng of banking competitors – including new market entrants, forward-thinking incumbents and non-banks – banks need to differentiate themselves in ways that are not easily duplicated. To restore confidence and realize strong future returns, banks must set the stage now. It will require uncommon innovation to stand out from the crowd and adapt successfully to marketplace demands.*

Samson lives in Soweto and works at one of the big factories near Johannesburg, South Africa. With Soweto's high crime rate, he is pleased to make small payments free of charge from his Mzansi<sup>1</sup> account using his mobile phone. Samson can now keep less cash in his pocket, finally making banking affordable, safer and convenient for him.

Luis, in his San Diego office, reads with interest an e-mail from his online bank that shows him how to better manage his finances. It provides a series of steps he can take to improve his credit rating over the next four months, and outlines the potential savings on his outstanding loans and credit debt.

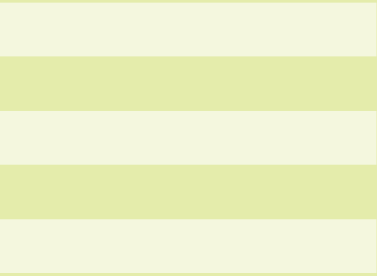
As he walks past a new electronics megastore in Bangalore, Anil receives on his mobile wallet a credit offer to buy a flat panel television.

Interestingly, the offer is from a U.S.-based bank taking advantage of the booming consumer credit market in India.

Heather, at home in London, is delighted that her bank finally lets her transact across different financial products – even different institutions – through the bank's own portal. No need to visit multiple sites to check account balances or transfer money among institutions. And, it's easy to optimize bonus points earned through her personalized loyalty program.

All of these people agreed on one thing: their banks were finally giving them useful tools that were tailored to meet their particular needs.

These futuristic scenarios demonstrate how retail banks can step beyond the expected; for example, by doing more than just improving the speed of existing processes and offerings.



Today, banks are pushing the limits of organic growth, and of growth via mergers and acquisitions (M&A). Increased competition and more discerning clients around the world mean it's more important than ever to stand out in the marketplace. So, how can retail banks differentiate themselves and continue to grow?

To distinguish themselves, banks must look beyond new product introduction and spread accountability for innovation throughout the organization. Shareholder value will be created by those that nurture the capabilities that support ongoing innovation, not just within bank walls, but also by looking outside the institution for new ideas, including partnering opportunities.

# Dare to be different

*Why banking innovation matters now*

**Retail banks are finding it harder to realize the gains they have come to expect – lasting innovation is vital for growth.**

## Reshaping banking to meet financial goals

From 1995 to 2005, operating profit margins flattened and returns on assets declined for retail banks of all sizes.<sup>2</sup> A decline in price/earnings ratios over the same period suggests that the market expects the future to be similarly dim. In this environment, banks will need to find new and better paths to growth by rethinking their differentiation strategies and making sustainable innovation a top priority.

### **The value of innovation in a changing industry**

As part of the IBM Global CEO Study 2006, we conducted in-depth, consultative interviews with 765 CEOs, business executives and public sector leaders from around the world.<sup>3</sup> Through these discussions, we explored CEOs' current views on innovation – what was on their innovation agendas, where their innovative energies were focused and what they were doing to enable innovation.

Fully half of the 84 banking CEOs interviewed expect extensive industry change over the next two years, with another quarter of them predicting moderate change. Banking respondents see innovation as vital to manage and profit from the expected influx of new client expectations, new market entrants, new products and new technology.

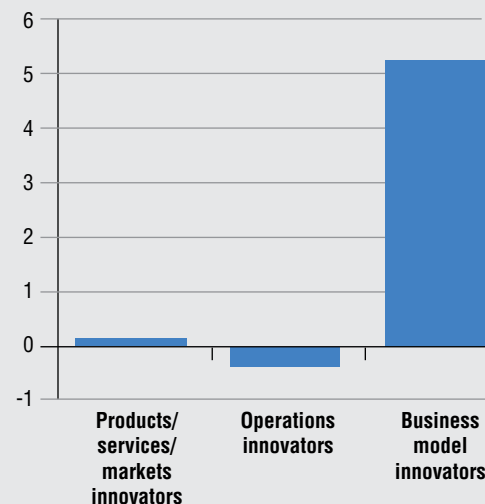
Three types of innovation were evaluated as part of the study:

- *Products, services and markets* – Develop new products and services, target new markets and audiences
- *Business and enterprise models* – Refocus, restructure and extend the enterprise
- *Operations* – Improve effectiveness and efficiency of core functional areas.

Of these three innovation types, the findings indicate that, across all industries, business model innovation had a much stronger correlation with operating margin growth than the other two types of innovation (see Figure 1).

FIGURE 1.  
**Operating margin growth in excess of competitive peers.**

*(Percent compound annual growth rate over 5 years)*



*Note: Companies over the last five years for each listed participant to its ten closest peers in the industry.  
Source: Global CEO Study 2006.*

**As industry boundaries blur, more opportunities exist to partner creatively and apply technologies in ways that inject new ideas into the business.**

**Profiting from a broader view of innovation**

For many banks, a past focus on product innovation has tended to serve only as a temporary differentiator because it is typically easy for competitors to imitate. By expanding their view to include business model innovation, leaders are aiming to improve financial returns and make it tougher for competitors to emulate them quickly. Figure 2 provides an overview of how the nature of innovation is changing.

Already, successful innovators are reshaping the industry – by looking beyond products and services to develop new business models and discover new ways to gain operational effectiveness. Through creative partnering, for example, banks can increase their footprints and delivery capabilities, and address evolving customer needs faster and less expensively than if they only look internally.

In addition, industry boundaries are blurring:

- Outside players are stepping into spaces that normally fall within the realm of banks, such as payment handling

- Nimble banks are seizing new growth opportunities by expanding into complementary industries (also described as *adjacent spaces*) that can benefit from banking services, such as providing a link among healthcare service providers, insurers and a bank.

Change is also evident across the retail banking business as new technologies are applied to tackle critical business issues and meet customer needs in innovative ways. For example, to accept and make payments, banks and non-banks (such as telecommunications companies) are bypassing legacy infrastructure through partnering and the smart use of technology, such as allowing customers to make payments via contactless cards or mobile phones.

Some outstanding retail banks have focused on uncommon differentiation for many years and are achieving strong financial results. But, overall financial results for the industry aren't going to rebound through a "business as usual" approach. To restore confidence in future returns, banks must set the stage now for meaningful innovation.

FIGURE 2.  
**The changing nature of innovation.**

<i>Features of historical innovation</i>		<i>Features of future innovation</i>
• Focus is on product and service innovation	➔	• Broad agenda includes business model innovation
• Development and technology driven	➔	• Customer and technology driven
• Research and development (R&D) plays a central role	➔	• Leadership and individuals play key roles, while R&D is one of many processes that prioritize innovation
• Closed and internal to the enterprise	➔	• Open and collaborative, across organizational and corporate boundaries
• Technology is a differentiator	➔	• Technology and business integration are differentiators

Source: IBM Institute for Business Value.

## Prime business areas being reshaped by innovation

Successful banks must continue to use new and existing capabilities to seize opportunities inside and outside of traditional banking confines. Amid the expanding array of new entrants and new technologies, differentiation can be achieved in many ways. The following business areas hold great promise for banks as recent innovations are already revamping the industry:

- Retail payments
- Mortgages
- Customer experience
- Under-banked customers
- Adjacent spaces.

### ***Retail payments***

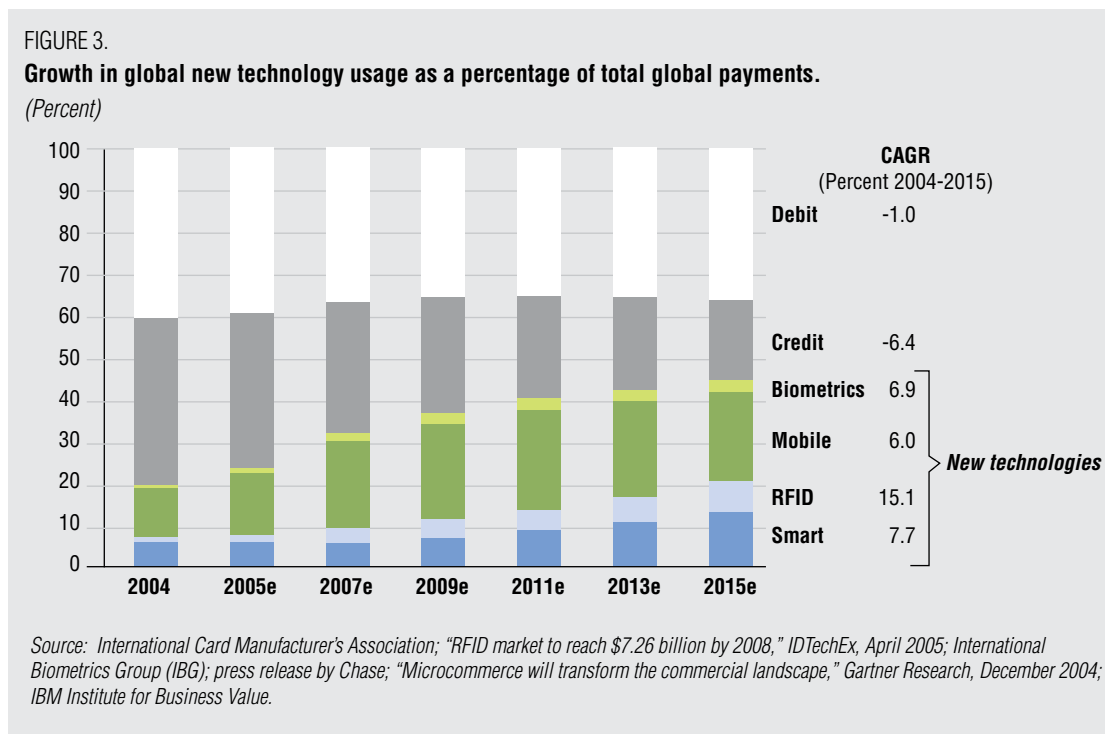
Innovative players are using new technologies to protect and grow share in the retail payments market, worth over US\$525 billion<sup>4</sup> and comprising up to 40 percent of U.S. and 10 percent of European banks' revenue.<sup>5</sup> Based on their core competencies, this business could be a natural fit for banks. But, meeting customer needs and staying competitive will require a portfolio of payment innovations.

We believe a variety of technologies will offer innovative possibilities for retail payments:

- *Contactless* – Radio Frequency Identification (RFID) will likely experience strong growth due to its speed and convenience. Smart cards are popular in Europe and Asia, but U.S. growth has been slow due to lack of merchant incentive and demand.
- *Mobile* – Mobile payments are increasing globally, with some banks participating in alliances, but telecommunications companies are leapfrogging banks in many markets (for example, ring tones and gaming). U.S. and European growth has been limited due to card dominance, technology requirements and lack of standards.
- *Biometrics* – Demand for biometric authenticated payments will grow due to faster and more secure account access. Transaction fees are significantly lower than credit or debit cards.
- *Online payments* – Reduction of the high unit cost for processing payments online is expected to drive the projected increase in online digital merchandizing. As online payments and e-checks grow in popularity, both have the potential to take more revenue from banks.

Figure 3 illustrates the growth in the use of new technologies in the retail payments area. As retailers and other emerging technologists push to grow market power and squeeze

payment fees, it will become even more critical for banks to implement new payment technologies to protect their dominant role.



**Globe Telecom: Mobile payments success<sup>6</sup>**

Globe Telecom, a telecommunications company based in The Philippines, shows how telecoms can lead payments innovation. About 33 million Filipinos send 200 million cell phone messages a day. Globe Telecom offers G-Cash, the only cashless and cardless payment platform in the Philippines. G-Cash users send and receive funds, and can make bill payments via text messages. Accepting payments through text messages reduces the risk associated with collection and money transfer.

Since its launch in late 2004, G-Cash has continued to innovate by partnering with Rural Bankers' Association of the Philippines to reach and profitably serve customers that previously had limited or no access to banking services. As of March 2006, there were approximately 1.3 million G-cash users generating US\$100 million in payments per day.

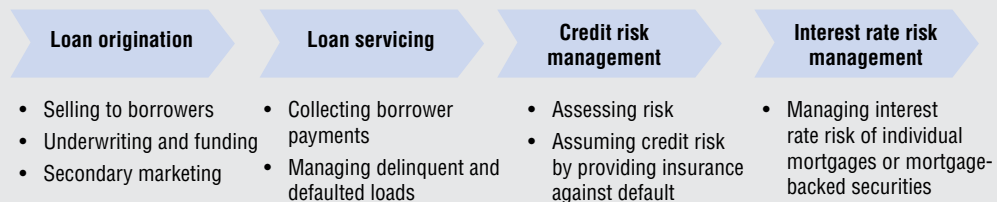
## Mortgages

Competition, peaking demand and shrinking margins are greatly impacting the global mortgage market. Total mortgage loans outstanding in Europe at the end of 2005 were €5.2 trillion (US\$9.3 trillion) according to the European Mortgage Federation – a 12 percent increase over 2004.<sup>7</sup> In the U.S. the Mortgage Bankers' Association reports there are US\$12 trillion in outstanding loans.<sup>8</sup>

Innovation and efficiency are more important than ever. And, even more crucial than the ability to offer new mortgage products is the ability to develop new processes and new business models. Within the mortgage area, operations are the differentiating factor. Over time, the conventional mortgage business has become increasingly fragmented, as players specialize in certain segments of the value chain. (see Figure 4).

FIGURE 4.

### Potential mortgage processing improvements in an increasingly fragmented mortgage value chain.



Source: IBM Institute for Business Value.

### IndyMac Bank: Innovation in the mortgage process<sup>9,10</sup>

IndyMac has long been recognized as a leader in the application of technology to mortgages. IndyMac was one of the first to offer an automated Web-based, mortgage underwriting system. It also provides financing secured by single-family homes and other banking products to facilitate consumers' personal financial goals.

As part of its focus on building customer relationships and a valuable consumer franchise, Indymac offers:

- Immediate access to multiple loan programs – Parallel risk-based pricing and evaluation of several loan types simultaneously
- Rapid decisions on loan funding – Down from three weeks to under a minute
- One-door policy – Borrower information is keyed in only once for use in various proprietary lender systems
- On-line tracking – For processing status, conditions and documentation
- Increase in pull-through ratio – Up from 50 percent to over 70 percent.

IndyMac moved from being the 33rd largest mortgage company in the U.S. in 1999 to 11th position in 2005 (a 41 percent CAGR in mortgage production) – at a time that the industry grew by 8 percent. Average annual return to shareholders over 1993-2005 was 23 percent, compared with returns on the Dow Jones Industrial Average of 12 percent over the same period.

Innovative banks will specialize in selected parts of the mortgage value chain – typically loan origination or servicing – then seek differentiation in their chosen area of specialty. For mortgage originators to be successful, they will need customer relationships and large volumes of new loans. Servicing specialists will rely upon scale to keep their costs low.

We expect these key innovations in mortgage processing to influence banks:

- *Personalization* – The customization trend includes mortgages that offer reward points or the ability to occasionally skip payments. Technology is enabling more flexible underwriting approaches, including the use of data that has not typically been part of credit reporting, such as repayment history based on geography, tax records or even how school tuition payments are managed.
- *Automation* – Automated underwriting software can shorten loan approval from days to minutes. Automated appraisals and collateral review are reducing cycle times, cost and systemic risk.
- *Outsourcing* – Banks are increasing their effectiveness by relying on outside providers for processing and activities outside their core competence.
- *Bundling* – “Offset programs” allow mortgages to be bundled with savings and checking accounts to reduce the impact of mortgage interest, giving traditional banks an edge in building customer relationships and getting more of their business.

**With customers who are more discerning than ever, banks cannot afford to overlook the value inherent in offering an unmatched customer experience.**

### **Customer experience**

Demanding, informed consumers are making customer experience an increasingly important opportunity for differentiation. For years, retail banks have talked about deepening relationships to gain customer trust and loyalty to counteract the effects of commoditization, but many still struggle with doing so. A stronger focus on customer experience should enable banks to raise the industry's 70 percent customer satisfaction rate and reduce the 24-month turnover rate of 50 percent.<sup>11</sup>

Leading customer experience innovations include:

- *Loyalty programs* – Although widespread and largely undifferentiated, loyalty programs remain a customer enticement. Some loyalty programs allow customers to create personal rewards programs. Recent successes have focused on customer relationships, rather than a specific product.
- *Enhancing branches to engage the community and increase sales of bank products* – Since remote banking precludes cross-sell opportunities and 90 percent of customer relationships are formed in branches,<sup>12</sup> banks are upgrading and expanding their branches, often using an informal approach via tellers, information kiosks and children's play areas.
- *Customer relationship management (CRM) and personalization* – Both are being used to create a powerful database of customer insights to help banks effectively target messages and manage customer relationships. The 50 billion global ATM transactions per year provide opportunities for personalized communication.<sup>13</sup>

- *Product integration* (such as linking accounts to credit cards, savings accounts, loans and insurance) – By integrating products in this way, banks get the chance to build customer loyalty through lower prices and customization.

### **Umpqua Bank: Branch innovation drives traffic and revenue<sup>14</sup>**

Umpqua Bank, based in Oregon, has a culture rich in innovation and collaboration. In 1995, Umpqua began redesigning its branches into a blend of upscale retail and bank. Aiming to provide a unique, top-notch customer experience modelled after the hotel industry, it built small, neighborhood banks designed to generate heavy foot traffic.

Essentially the opposite of remote banking, these branches create relationships and improve cross-sell opportunities. With no parking lots or drive-through windows, customers come inside to enjoy Umpqua coffee, chat in comfortable chairs and even partake of neighborhood-specific concierge services. A video Discover Wall uses RFID technology to grab the attention of passersby outside; once inside, they can selectively launch sales pitches and descriptions of bank products and services.

Response to the "retail feel" branch design, which Umpqua patented in 2004, has been overwhelmingly successful. Within two years of opening the 1995 test store, Umpqua rose to the top spot in market share in the area.

### ***Under-banked customers***

Market saturation has led retail banks to get creative in reaching previously untapped customer segments. In the past, there were many groups of people that banks didn't pursue as customers for various reasons, but generally because they were not considered to be potentially profitable to serve. Today, new technologies enable cost-effective ways to serve the over 3 billion "unbanked" adults in emerging and developed markets.<sup>15</sup> Banks are discovering the profit potential in reaching these groups when services are provided to them differently.

Among the recent innovation opportunities related to under-banked customers are:

- *Consumer credit extension* – A system that uses nontraditional measures to develop credit scores, such as rent and utility payment history, qualifies a broader group of customers for mortgages and offers credit lines for as low as US\$75.
- *Portable banks* – Located in high-traffic or poor, rural areas and operating as ATMs, this type of bank offers programs to encourage savings. Depending on geography, mobile marketing teams may also push services to hard-to-reach people at malls, offices and residential areas.
- *Money remittance* – Especially useful to immigrant populations, this service aids customers who want to send money to their home countries. Many large global banks are designing programs specifically to tap into the nearly 20 million U.S. Hispanics who use remittance services, but do not have bank accounts.<sup>16</sup>

- *Microfinance* – Extending customer relationships beyond credit cards, technology and flexible business models are enabling banks to profitably offer small business loans to impoverished people around the world.

### **Bancolombia: Microcredit offerings reach unbanked population**

Microcredit, especially in developing countries, enables very poor people to engage in self-employment projects that generate income to help bring them out of poverty. Access to financial services varies from as low as 1 percent in some developing countries to above 90 percent for OECD countries.<sup>17</sup>

Microfinance offerings can boost banks' revenue and expand presence in underserved markets. For example, over 60 percent of Colombia's population is unbanked.<sup>18</sup> Bancolombia, based in Medellin, Colombia, was created in 2003 and is Colombia's largest bank.<sup>19</sup> Its microcredit program aims to provide microentrepreneurs with financing opportunities. Bancolombia uses cutting-edge technology and an adaptable suite of products and services, including tailored risk and credit models.

To execute the program, Bancolombia integrated new capabilities into existing bank platforms, applications and channels. In preparation, it sent top management on a tour of best practice banks and microfinance institutions (MFIs) in Latin America, and hired and extensively trained 25 new employees. As of April 2005, the program had more than 3800 clients, and the average number of products per customer rose from 1 to 3.46.

**Moving outside their traditional realm, retail banks see great growth potential in applying their existing strengths to adjacent spaces, including healthcare and electronic payment processing.**

***Adjacent spaces: Healthcare and electronic payment processing***

Retail banks can leverage their core capabilities profitably in other industries, too. This has the added advantage of strengthening the ties between banks and their customers by making processes more efficient for all stakeholders.

For instance, banks can profitably extend their core payments and credit capabilities to the US\$2.8 trillion healthcare market.<sup>20</sup> Entering the trade and electronic payment processing businesses also offers huge opportunity for banks – the projected U.S. purchase card transaction volume in 2006 is expected to reach US\$138 billion, a compound annual growth rate of 13 percent over the last five years.<sup>21</sup>

***Healthcare***

Innovation opportunities associated with healthcare include partnering with healthcare providers to offer seamless services linking insurers, tool providers (such as WebMD) and payment processors. Banks can also generate fees for managing plans, payment processing, reporting and enrollment services, while lowering costs and making life easier for plan participants and healthcare providers.

In the U.S., there is a substantial opportunity to develop integrated end-to-end processes linking plastic (debit and credit) to savings accounts, with underlying asset choices that are associated with Health Savings Accounts (HSAs) and Flexible Spending Accounts

(FSAs). Healthcare spend is rising at 8 percent CAGR, from US\$1.2 trillion in 1998 to US\$2.8 trillion in 2010.<sup>22</sup> HSAs and FSAs are expected to increase to 29.1 million accounts, from 17.3 million in 1998 and grow to more than US\$75 billion in assets by 2010.<sup>23</sup>

Americans spend more than US\$350 billion in out-of-pocket medical expenses each year.<sup>24</sup> To help bridge the gap between costs covered by health insurance and the amount of actual medical fees incurred, HSAs have growing appeal for both employees and employers.

For individuals, HSAs entail setting aside pre-tax earnings for future payment of eligible medical expenses, as needed. Tax-deductible contributions to HSAs can earn higher returns than regular savings accounts and balances carry over from year to year. Among the benefits to U.S. employers, HSAs reduce their tax burden because their employees' pre-tax contributions lower the gross payroll amount.

Better approaches are clearly needed: current processes are inefficient and paper-based with high payment processing costs; multiple platforms and players are typically involved. Healthcare firms – and, in some cases, banks – are developing capabilities and establishing strategic partnerships to seize the HSA opportunity.

### **Exante Bank and United Health Care: Apply bank capabilities to enter U.S. healthcare account management**

In 2002, United Health Care created its own bank, Exante Bank. It offers HSA-related financial services that simplify the customer experience. Exante Bank intends “to enhance the health and well-being industry by integrating the proven platforms of the financial services sector – bringing innovation, reliability and security to benefit delivery, health care administration and transactional processes”<sup>25</sup> Exante CEO John Prince said, “The goal is to create a completely different experience for consumers and the provider after they’ve gotten their health care.”<sup>26</sup>

As of February 2006, Exante Bank had 115,000 accounts totaling US\$75 million in HSA deposits.<sup>27</sup> Earnings were US\$.75 per member per month (based on an average number of transactions per month), and an average of 12,000 new HSAs were being opened per month.<sup>28</sup>

### ***Electronic payment processing***

In another natural extension of what banks are already good at doing, innovation opportunities lie in making life easier for customers in the area of electronic payment processing. Innovations in this area can strengthen existing client relationships and improve profit potential. However, banks need to act quickly to upgrade their trade service capabilities or risk losing revenue to third-party providers.

Banks can begin by building on existing payments offerings (such as a purchasing card). Then, they can partner with a platform supplier, or develop an offering for outsourcing and integration of buyer/seller processes. Alternatively, banks can enter this market rapidly through partnerships or acquisition of existing providers.

Innovation opportunities associated with electronic payments include:

- *Electronically integrated procurement, invoice presentment and payment (EIPPP)* – For business customers, banks can earn new revenues by using software to link buyers and sellers through the bank. This makes purchasing and payments processes more efficient, and lowers payment and credit risk.
- *Electronic bill presentment and payment (EBPP)* – For consumers, EBPP provides electronic bill payment, shortened payment lead times, increased security features and better usability. Banks can also partner with billers to build comprehensive offerings based on access to the billers’ customer bases.

## Creating the environment for ongoing innovation

Along with ongoing commoditization of so many banking products and services, industry consolidation and competition from smart players are all adding to the pressure to be distinctive. Doing this requires a sturdy innovation infrastructure that helps banks merge appropriate opportunities with capabilities (see Figure 5). As a result, companies can begin to consistently execute in innovative ways.

As a first step toward improving your ability to create sustainable differentiation, think through your answers to the following questions:

### 1. Enhance the innovation infrastructure

- Does your prioritized portfolio of initiatives include operations and business model innovation?
- How much of your innovation is bold and differentiating?

### 2. Manage and reward innovation

- How do you maintain a culture that encourages and rewards innovation?
- What formal mechanisms are in place to identify and implement innovative ideas?
- How do you encourage controlled risk-taking and experimentation?

- Which processes help you monitor and measure innovation initiatives?

### 3. Collaborate and partner

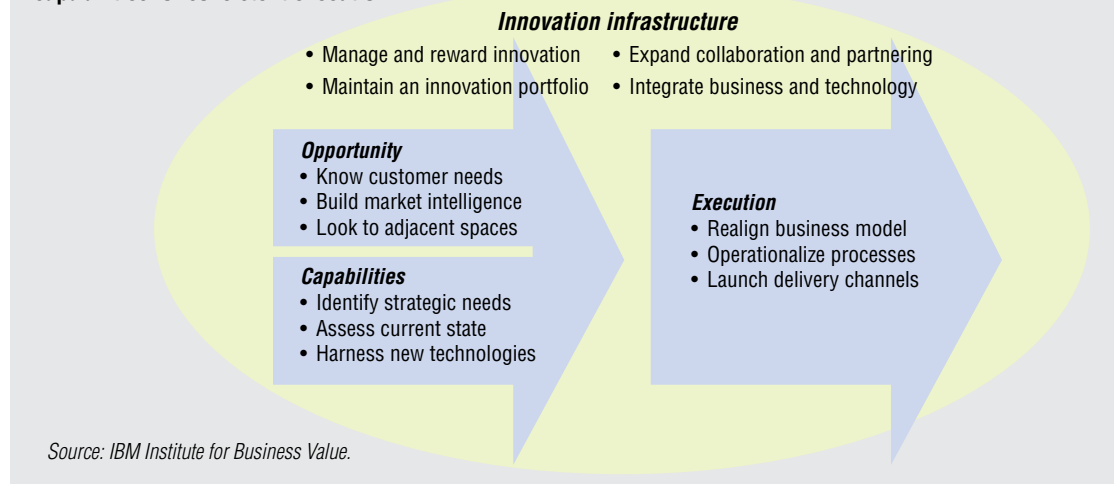
- How effectively do internal product, geography and functional teams collaborate?
- How often – and to what effect – do you look outside your organization for ideas and capabilities?
- Which tools, structures and processes do you use to support collaboration?

### 4. Integrate business and technology

- Do you systematically explore new technologies that could change your business?
- Is technological change an input to your strategy, or just an enabler?
- How do you match business needs with new technologies?

To meet the challenge of distinguishing your retail bank from all of the other banking options available today, thinking in terms of change alone is only half the battle. It isn't enough just to do something better – you'll need a robust innovation infrastructure that allows your bank to be recognized by consistently offering better value in different ways.

**Figure 5. Constructing a strong innovation infrastructure: Merge appropriate opportunities with bank capabilities for consistent execution.**



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### Related publications

Hedley, Kimberly, John White, Cormac Petit and Sunny Banerjea. "The paradox of Banking 2015: Achieving more by doing less." IBM Institute for Business Value. November 2005. <http://www-1.ibm.com/services/us/index.wss/ibvstudy/imc/a1022912>

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### About the authors

Sunny Banerjea is Americas Banking Leader, responsible for driving the banking strategy and business in the U.S., Latin America and Canada. His expertise is in identifying and building profitable, high-growth businesses, managing innovation initiatives, and leading the development of thought leadership and corporate strategy. Sunny is sought after as a speaker, a globally recognized Subject Matter Expert, an advisor to C-Level executives and IBM industry spokesperson via numerous articles and interviews. Sunny can be reached at [sbanerjea@us.ibm.com](mailto:sbanerjea@us.ibm.com).

Robin Kahn is a Consultant in the IBM Institute for Business Value. She holds an MBA from Columbia University and has over twenty years of business experience. Prior roles in equity research, management consulting and strategic marketing have contributed to her strong interest and expertise in the financial services arena. Robin can be reached at [rkahn@us.ibm.com](mailto:rkahn@us.ibm.com).

Cormac Petit is a Chartered Accountant (South Africa) and Managing Consultant in the IBM Global Business Services Strategy and Change practice. He has over twenty years of experience worldwide and across a wide range of industries, with primary expertise in the Finance Sector. Currently in the IBM Institute for Business Value, Cormac is responsible for the Banking competence in Europe, the Middle East and Africa. He has published many research studies and articles in a variety of journals, and speaks regularly at conferences. Cormac can be reached at [cormac-petit@nl.ibm.com](mailto:cormac-petit@nl.ibm.com).

John White is a Managing Consultant in the Financial Services practice of the IBM Institute for Business Value. He has extensive experience formulating global growth and transformation strategies for financial services, software and technology services companies. John has authored multiple strategy studies that provide relevant, viable recommendations for using technology to improve business results. He currently focuses on developing intellectual capital to address banking industry issues at the intersection of business and technology. John can be reached at [jmwhite3@us.ibm.com](mailto:jmwhite3@us.ibm.com).

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With consultants and professional staff in more than 160 countries globally, IBM Global Business Services provides clients with business process and industry expertise, a deep understanding of technology solutions that address specific industry issues, and the ability to design, build, and run those solutions in a way that delivers bottom-line business growth.

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Route 100  
Somers, NY 10589  
U.S.A.

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