



Bankers As Buyers

***A collection of research, opinions and articles about
what bankers will buy in 2005***

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For many years, a major financial publications company provided an invaluable tool to help vendors and others with their marketing planning by compiling a comprehensive collection of research and data. For a variety of reasons, this annual study was discontinued, and it left a void for those who used it as an integral part of their marketing planning.

Because the mission of the William Mills Agency is to help companies market to financial institutions, we were acutely aware of this void and, in 2002, we decided to publish *Bankers As Buyers* as a service to our clients and others who might be interested.

This year's *Bankers As Buyers* offers research statistics, observations and predictions from some of the most knowledgeable consultants and professionals currently involved in the financial industry. This year's survey has been greatly enhanced by information provided by, or originally published by:

- AMR
- Celent Communications
- Cornerstone Advisors
- Datamonitor
- Edgar, Dunn & Company
- Financial Insights
- Financial Executives International
- Forrester
- Gartner, Inc.
- Gallagher Systems Group
- Independent Community Bankers of America
- Javelin Strategy & Research
- Reynolds, Bone & Griesbeck PLC
- TowerGroup, Inc.

It is our pleasure to provide you with this 2005 edition of *Bankers As Buyers*.

Sincerely,

A handwritten signature in cursive script that reads "Scott Mills".

Scott Mills, APR
President
William Mills Agency

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I. Spending Outlook

Financial institutions will increase their technology spending in 2005, most analysts agree, though the amount of growth is somewhat in dispute. While no one predicts a large jump in expenditures like the eight percent annual growth of the late 1990s, increases from a couple of percentage points to the mid-single digits over 2004's numbers will likely be necessary for financial institutions to continue to battle the increasing fraud issue, meet growing compliance needs, maximize efficiencies across the enterprise and meet the demands of the changing payments system.

“TowerGroup sees fundamental shifts in the way financial institutions will manage their estimated \$362 billion in IT investments in 2005, as technology affects the productivity of over \$2 trillion in global operational expense,” said Guillermo Kopp, vice president of the TowerGroup Cross-Industry research practice. “Financial institutions will implement process and technology changes in more manageable chunks, and employ business process management and networked services as pivotal elements for strategic transformation.”

Kopp added that it will be increasingly critical for financial institutions to lay out a strategic road map to cut across organizational silos and fulfill their customers' needs more proactively. “This is something the industry has talked about for years, but has been hard-pressed to implement effectively,” he said.

TowerGroup estimates that overall IT spending in the global financial services industry will rise from \$360.9 billion in 2005 to \$408.6 billion in 2008, for a compound annual growth rate of 4.2 percent.



Internal and External IT Spending in the Global Financial Services Industry (1996-2008)

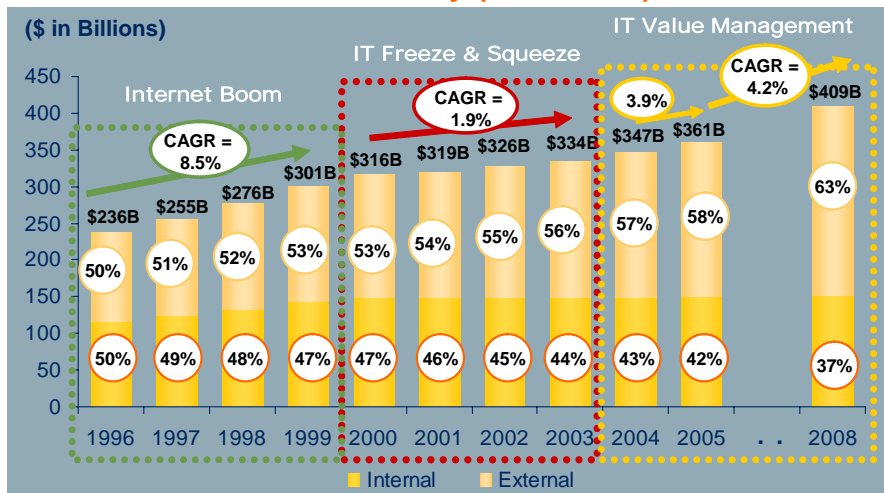


Exhibit #: 41:27B-E1
Source: TowerGroup

In 2005, TowerGroup expects the predominant theme in financial services IT spending to be investments at the architectural level in data, content and business process management, as well as in integration technologies.

Datamonitor predicts that global financial spending will increase only slightly. Forty percent of the respondents to a Datamonitor survey said they are planning no change in their IT budgets. Financial institutions are cautiously positioning themselves for a slight upturn, but remain largely in a defensive position, Datamonitor said.

According to the December CFO Outlook Survey, conducted by Financial Executives International and Baruch College's Zicklin School of Business, participating CFOs expect capital spending at their companies to increase by 14 percent in the next 12 months. These projections were made despite more than half (56 percent) saying their companies have felt the impact of rising producer prices in the last quarter.

When asked about permanent changes resulting from Sarbanes-Oxley Section 404, 57 percent said they had made “no substantive changes.” Others noted some positive changes. Thirty percent cited better control over documentation of systems changes, while 21 percent said they invested in a technology solution to monitor compliance and maintain and store internal control.

Terrence Roach, principal for Cornerstone Advisors, Scottsdale, Ariz., expects technology spending to remain constant at 25 to 30 basis points of a bank’s asset size. So a \$100 million bank would spend \$2.5 million. That percentage has remained relatively constant for the last six years, according to Roach. So a bank’s spending will grow largely based on its asset growth.

“Unless you have a big acquisition, it remains relatively consistent,” Roach said.

Gartner, Stamford, Conn., expects investment firms, banks, healthcare payer organizations and insurers to exploit new technologies and strategies to successfully manage their demanding and changing market environments in 2005 and beyond.

In the four key segments of the financial services industry that Gartner follows — banking, investments, insurance and healthcare payer organizations (payers) — companies are struggling to create and enhance knowledge. The goals behind this pursuit are:

- Improving operational efficiency and enterprise profitability
- Revamping critical business processes that must be shared effectively among internal business units and external business partners
- Focusing on information management at the company level

- Increasing revenue by focusing on new markets, improving customer retention and exploiting technology to address changing customer needs
- To attain knowledge and achieve these goals, financial services firms must embrace opportunities for the innovative use and reuse of technology by refreshing their thinking and exploiting technology. This broad theme — the innovative use and reuse of technology that drives the pursuit of knowledge to achieve economic vigor — forms the basis of Gartner's predictions for 2005.
- Investment firms will confront an increasingly complex marketplace in 2005 and beyond. Market and regulatory forces beyond their control present these companies with the urgent need to adapt or fall behind.

Therefore, Gartner said that banks and other financial institutions must juggle the intersecting needs of finding new customers with exploiting the data hidden inside their systems to mitigate risks.

II. Spending Breakdown

Entering 2005, the proliferation of increasing hacker attempts via viruses, worms, phishing, Trojan horses, and older methods including check forgery, kiting, etc., put fraud prevention and detection at the forefront of many banks' technology spending lists.

However, many of those technology investments will be relatively small, with projects handled by a department or a line of business, according to Jeanne Capachin, research director for the banking practice of Financial Insights, Framingham, Mass.

Banks won't make enterprise-wide investments in fraud prevention technology until they first upgrade/revamp their technology infrastructure on an enterprise-wide basis so that systems themselves are enterprise-wide. Many of the nation's largest banks have grown primarily through mergers and acquisitions, and therefore have added a variety of front-end and back end systems that were never designed to work with one another.

In an interview with *ABA Banking Journal*, Gartner analyst Susan Cournoyer said that banks *are* spending on server consolidation and efficiency. Celent also pointed to the need to clean up middle-tier architecture at many financial institutions, replacing a hodgepodge of systems with a uniform, services-based architecture.

A. Fraud Prevention

Only the nation's largest banks (roughly the top 20) have systems integrated enough that they are approaching identity theft/fraud prevention on an enterprise-wide basis, adds Sophie Louvel, Financial Insights analyst.

Phishers are getting better at what they do, Roach said. Phishers, hackers and other fraudsters continue to use more powerful technology. So financial institutions have no choice than to upgrade their own fraud-fighting technology, by adding firewalls, neural networks and other fraud-fighting hardware and/or software.

Roach likens the increase in phishing attempts, which have targeted consumers with e-mails not only allegedly from many of the nation's largest financial institutions, but also increasingly from community banks, to the growth in counterfeit attempts of the early to mid-1990s. The growth in counterfeiting spurred the development of new currency with enhanced security features. Yet counterfeiting still occurs.

Some of the nation's largest banks (below the top 20) will make \$5-million plus investments to rectify this problem in 2005, according to Capachin. These projects will be larger than any single fraud prevention/detection expenditure, though there will be many more projects in the security arena.

Another reason all but the largest banks won't be looking immediately at enterprise-wide security systems, according to Capachin, is that enterprise-wide systems take a good deal of money and time to install, and banks need to address fraud issues on a more immediate basis. Indeed, the press, bankers, analysts and regulators have pointed to the rampant increase in phishing and other types of fraud.

B. Community Bank Perspective

In a recently released survey of its membership, Independent Community Bankers of America found that those with more than \$100 million in assets were facing the following long-term technology decisions:

- Systems security 65 percent
- Telephone banking issues 60 percent
- Staying up to date on existing technologies 57 percent
- Keeping technology affordable 56 percent

Additionally, the survey said that 59 percent of banks with more than \$100 million in assets expected to increase their technology spending in 2004. That trend is likely to continue in 2005. Just over half (55 percent) said their technology is on target. Twenty-three percent said their technology is behind where they want it to be. One percent said their technology is far behind where they want it.

To handle the security issue, many community banks will turn to third-party security management services, according to Jimmy Sawyers, director of consulting for Reynolds, Bone & Griesbeck PLC, Memphis, Tenn.

"Bankers know that more fraud detection is important, but they also know that there is no magic bullet," Sawyers said. "You don't just go out and buy ABC fraud detection." Auditors are taking a closer look at banks' fraud detection practices as well, Sawyers added.

C. Regulatory/Compliance Spending

Despite continued efforts – particularly by community banks – to get some regulatory relief, the fact is that financial institutions have an increasing regulatory burden to contend with every year. There was actually a recent benefit of sorts from these regulations in the last year – many experts agree that banks were better prepared than many other industries for the Sarbanes-Oxley rules, though they still add to the regulatory/compliance burden.

One of the major ways for banks to meet the growing list of regulatory requirements is through technology. Systems that automate some of the compliance requirements will continue to be in demand.

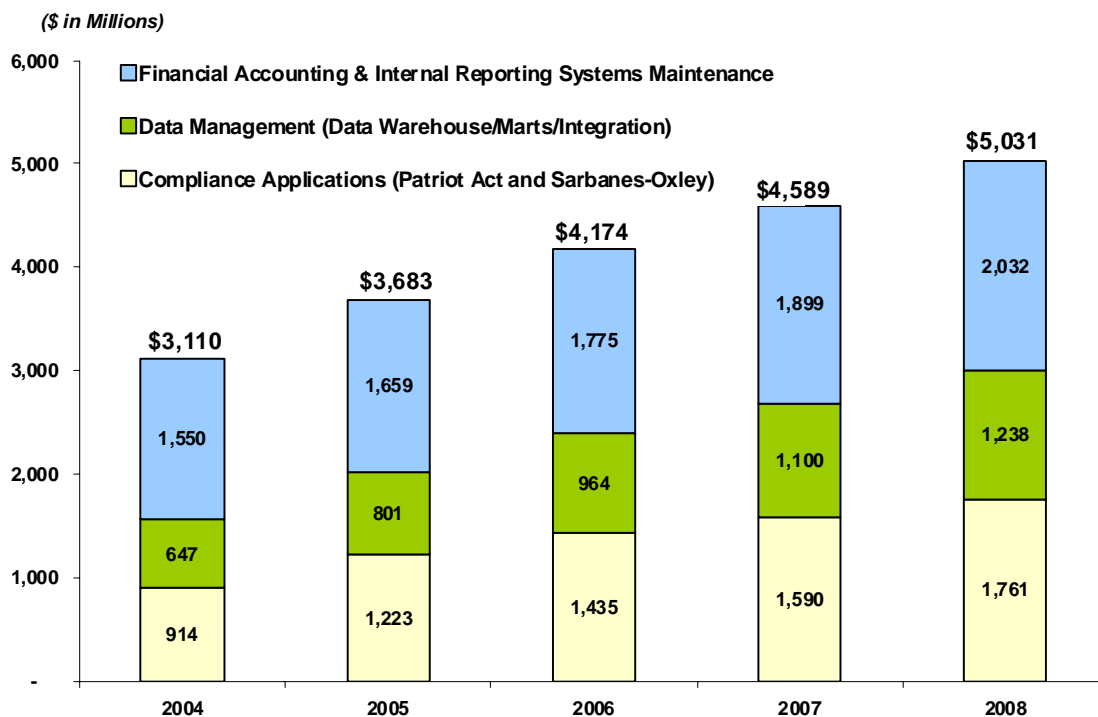
Key IT compliance issues facing bankers in 2005 include:

- Section 404 of the Sarbanes-Oxley Act, which requires publicly traded companies to report on internal financial controls. Most privately held banks and other companies will be expected to comply with the law as well, experts say.
- USA Patriot Act (anti-money laundering)
- Gramm-Leach-Bliley Act (risk assessment, policies)
- More stringent IT examinations (wider scope, more frequent)

“Regulators are slapping enforcement on bankers quicker than ever before. Regulators are being punitive in dealing with non-compliance,” Sawyers said. “So bankers are looking at systems to better help them avert that disaster.”

Though technically, Section 404 of Sarbanes-Oxley applies only to banks with publicly traded shares and capitalization of more than \$75 million, the reality is that all financial institutions have to adhere to the rules because suppliers, investors and regulators will expect it. Terrence Roach, principal for Cornerstone Advisors, calls (SOX Section) 404 “the three numbers that bankers hated most in 2004.”

Financial Insights provided the following projections on compliance technology spending:



Due to recent mutual fund scandals, the issue of SOX/corporate governance comes to the forefront for asset managers, according to Datamonitor. Corporate banks are dealing with credit risk as well as with any governance issues.

Though customers may be largely unaware of SOX, other bank constituents, such as investors, suppliers and regulators will expect to see bank compliance with the rules anyway. According to an AMR Research study, SOX spending for all companies will grow to \$5.8 billion in 2005, with 28 percent of that money spent for technological solutions.

Therefore, banks will be investing in core accounting systems while automating the documentation of internal controls.

D. Customer Service

While the term CRM still brings images of some failed early projects, there's no question that customer service becomes more of an issue as banks' products become more commoditized.

Sawyers expects financial institutions to use more customer satisfaction surveys – both online and offline – to provide better customer service.

One way will be to upgrade Web-related services. As more customers obtain broadband communications and more powerful computers, they will be more likely to go online for bill payment, account information and other financial services needs, Sawyer said. While most banks already have an online presence, even some \$1 billion-plus banks have very static sites. According to the ICBA survey, 18 percent of members still don't have an Internet site. 13 percent of consumers with Internet access have a broadband connection.

Forrester Research points out that more companies wishing to improve customer satisfaction and retention are moving to more sophisticated service and eService software to meet ever-increasing customer expectations. Yet these technologies are still evolving, and newer channels make any spending projections moving targets.

E. Payment Systems

Between 2004 and 2007, the number of bill payments made via a bank's Web site is expected to grow 37 percent annually, according to Celent Communications. Celent adds that rising processing expenses could force banks to consider alternatives to the legacy payment infrastructure.

Celent noted that the check's share of total consumer bill payments is crumbling. By 2007, there will be as many bill payments made over the Internet as by check, and as little as 29 percent of consumer bill payments will be settled by check - down from 53 percent in 2004.

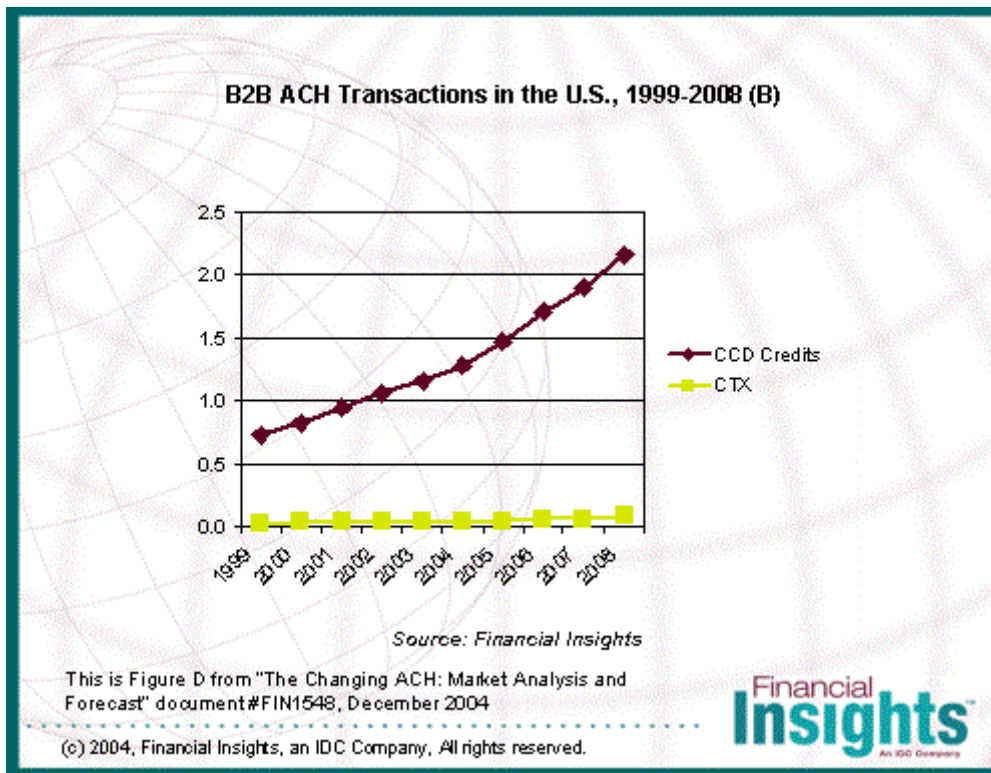
"Banks and their processing partners will be increasingly confronted with the options of making massive investments to fix the current paradigm," said Gwenn Bezardm, Celent senior analyst, who researched consumer bill payments.

According to research by Financial Insights, NCR and NetDeposit, growth in image exchange and check truncation prompted by the Check Truncation Act (Check 21) has boosted investments in ARC (Accounts Receivable Conversion) and POP (Point of Purchase conversion) as well as related systems within financial institutions.

As the number of checks continues to decline, the processing costs also continue to rise. So the challenge for financial institutions, the study says, is to reduce processing costs until entire check processing systems can be eliminated.

Check processing is a mature process, with no more efficiency to be squeezed out of the paper environment, many experts agree. To gain further efficiencies, banks need to convert paper checks to an electronic form as early as possible in the process, saving the cost of transporting the paper and eliminating the need for expensive check processing hardware such as reader/sorters.

By 2010, 90 percent of non-local transit items will be processed electronically, the study adds, predicting that spending on electronic check technology will be in the range of \$1.6 to \$2 billion in 2005 (with spending dropping to less than \$1 billion in 2006). By 2006, much of the spending then centered on extending image capability out to branches, ATMs and large corporate sites.



Many of the largest banks have already upgraded their systems, so it will be the next tier of banks, those with between \$4 billion and \$200 billion in assets

that will account for the majority of the spending, according to Financial Insights.

Though all banks spend on core infrastructure, most of the large projects are already completed, Roach added. He expects that many financial institutions will look to spend their technology budgets on integrating branch delivery with call centers and consumer lending.

“The big idea behind integrated delivery is building a shared history of customers, a single source of profitability information and demographic information that populates all of the delivery system,” Roach said. “Banks want the ability to reuse information without re-inputting data.”

F. Other Technology Spending

In a proprietary report, “Predicts 2005: Risk Management Will Boost Bank Performance,” analyst Doug McKibben says that banks must remove the barriers between their data initiatives to gain operational efficiency and respond more effectively to change. New technologies and new market segments offer banks opportunities and challenges.

According to analyst Maria-Luisa Kun, in “Predicts 2005: Banks to Target Underserved Customer Segments,” banks are missing out on a potentially lucrative group of noncustomers — the “unbanked” (those who don’t already have existing banking relationships).

However, reaching this group requires new thinking, as well as innovative products and services. In “Predicts 2005: Microcommerce Will Transform Payments,” analysts Susan Landry and Christophe Uzureau say that consumers want new, efficient ways to make small, everyday purchases. Micropayments, they explain, offer that capability and can provide banks and other businesses with new benefits, as well as new concerns.

So, though growth in bank technology spending will continue in 2005, much of the expenditure will be related to what financial institutions feel they “have to” do, namely, compliance and security, and replacing systems that just don’t meet their needs any more, as with Check 21-related changes. But proactive spending to take technological giant steps in systems and productivity will occur on a much more sporadic basis.

III. Feature Articles

Investing in an Integrated Banking Environment



Jeanne Capachin
Research Director, Banking Practice
Financial Insights

One way to measure the key issues that bankers are facing is to look at where they are placing their bets for the future. One analog that we use at Financial Insights is bank spending – specifically, which technology investments are being funded, at what levels, and are these investments growing, declining, or staying the same. Financial Insights surveyed 91 senior executives in chief technology officer’s offices in financial institutions worldwide to determine what each institution’s current top technology priorities were, what business purpose was driving investment in those priorities, and how IT spending was expected to change over the next few years. One key finding is that spending on infrastructure initiatives is strong across regions and banks of all sizes.

The survey data shows that infrastructure has become a greater priority for banks than it has in the past, and more so for banks than their brethren in capital markets and insurance. Capital markets firms have been ahead of the technology investment curve within the financial services industry, while insurance firms are rarely considered to be cutting-edge when it comes to IT infrastructure. For banks, it is increasingly important to link very diverse, siloed applications; to deal with complex data infrastructure needs (customer, compliance, and financial reporting); and to provide flexible environments to deal with merger activity. In addition, the infrastructure investments in banks are highly focused on reducing costs for the high volume of transactions they continue to process.

Drivers of Change

Mergers and Acquisitions. One key reason banks are focusing on their infrastructure is in response to acquisitions. Rounds of acquisitions have left their current operations unnecessarily compartmentalized and redundant. Those institutions driven by M&A activity are focusing squarely on

infrastructure improvements. But even for those banks growing organically and less focused on acquiring new businesses there was a modest, across-the-board influence of merger activity on technology priorities. It is no secret that if banks want to be well positioned to grow by acquisition, they need a flexible infrastructure, a scalable back office, and connectivity for all systems. Increasing geographic reach has driven much of the acquisitions from the last decade, however, we believe technology compatibility and opportunity will play a more critical role in the next wave of merger activity than it did during the merger wave of 1996–1998.

Flexible Enterprise. In the emerging integrated approach, the banking organization can use technology strategically as an overarching framework to support integrated profit, risk, and performance goals and to deliver products customers. Back and middle offices can evolve gracefully and without big-bang enterprise application integration via the creation of an architectural framework in the form of common data models, content and messaging standards, integration architectures, and workflow standards. On a small scale, as each business line's systems comes up for replacement, banks will evaluate the next system by how well it fits into that infrastructure. On a larger scale, banks will take on big problems with this standards-based architecture.

Integration as an Enterprise-wide Initiative

IT spending decisions are influenced not only by business priorities, but by the CEO or president's perception of technology within the institution. By definition, projects aimed at greater integration and more open technology must be addressed at the highest levels of the bank, and these projects will often have visibility at the highest management levels within the bank. Although most banks recognize inefficiencies in their current technology environment, it will take fortitude to invest sufficiently to achieve meaningful results. "Better, stronger, faster, cheaper" continues to be the mantra for senior bank executives when it comes to evaluating their technology investments. Some institutions stipulate a 12-month return on investment (ROI) from their new technology investments before they will approve them. Banks are continually looking to leverage more from their existing technologies and labor force, to execute functions with greater efficiency and speed, and to do both at a lower cost. Many are trying to rationalize the number of software applications that they use. By developing an open, integrated banking technology framework, banks can reduce redundancy, increase efficiency, and become more agile in their ability to develop new products and go to market quickly. Although payback for the entire investment may seem elusive, approaching investment by targeting pain points first and reinvesting savings from those investments in future projects is one way banks can both tackle this huge problem and reap short-term gains.

A growing number of leading banks are creating a more integrated architecture without unplugging the separate, isolated core applications supporting each line of business. This has been an evolutionary process that must also be addressed organizationally. Although a top-down C-level initiative, without

support in the trenches and a true organizational shift, an initiative based solely on technology will fail. As complex as siloed organizations look from the top-down, from the bottom-up the view can be very different. For individual lines of business, the siloed approach appears efficient and economical. It is when siloes must be spanned and integrated, the line of business approach fails to deliver. That is why organizational directives from the top down, partnered with business driven results aimed to the line of business are the only winning formula.

Looking forward to 2010, we expect a sea change in banking. We see progressive, global banks embracing and moving forward with a strategy that assumes an integrated bank enterprise (both technologically and organizationally) as the end state. This will not be achieved by replacing core bank processing systems. Rather, a new bank enterprise taxonomy will arise, and we are starting to see it today.

Moving forward, this strategy will require organizational change as well, but banking businesses will be more adaptable if the strategy is pursued to its completion. Take for example the corporate bank, where business is built on relationships, not technological features. It is relationship managers and loan officers that are the glue tying together banking products for large corporate customers. By taking the time to rationalize product delivery, data management, and data integration, banks can present a more complete face to their clients and take advantage of all the investments they have made to date, while removing the barriers that make it so hard to work across silos.

With a more flexible enterprise, corporate banks will then have the ability to integrate more deeply with their clients and respond quickly to market changes. This will be the route to new revenues, and it will provide the information-based services that clients desire and are willing to buy. Through partnerships and development alliances, banks will develop solutions that can bridge financial products and corporate supply chain events. Building an integrated banking architecture and realigning organizationally are the steps that a few forward-thinking banks are taking.

Top Trends Impacting Bank Technology for 2005



Jimmy Sawyers
Director of Consulting
Reynolds, Bone & Griesbeck PLC

Looking ahead to what bankers can expect in 2005, we find new challenges, some created by the increased use of technology but many that will be solved by new technology and its intelligent application. Technology now touches every area of the organization and is considered an important component in banks' strategic plans and compliance efforts.

To help bankers better plan for these new challenges, we offer ten predictions for 2005:

1. 2005 Will Be the Year of the Online Consumer

As more consumers get broadband Internet access from home, their online activity will increase exponentially, and we will see more rapid adoption of online banking services. Until now, many consumers had a technology mismatch in their homes, old PCs with broadband or new PCs with dial up. This made for an unpleasant online experience. New PCs and broadband are the winning combination that will finally break down the barriers to consumer acceptance of online banking and increase penetration of banks' customer base. Online sales figures for the 2004 holiday season will be the leading indicator of online activity expectations for 2005, and the early indications are for another record year of online sales.

2. Retail Delivery Goes Mainstream

As customers continue to demand multiple delivery channels and increased convenience, bankers will be forced to think more like retailers and less like traditional bankers.

Expect to see more titles like "senior vice president of the customer experience." Branches will be referred to as "stores." These "stores" will resemble your local Starbucks more than your average bank branch. Bankers will focus on customers' life events not just their transactions. Branches are being designed with more of a retail feel. Banks should start thinking about their branches as

a retail store. Signage will be reviewed as bankers learn from studies such as the one from “Retail Anthropologist,” Paco Underhill, author of *Why We Buy*, that found there is a three-second window to catch a consumer’s eye. As a result, branch technology becomes more of a strategic tool to help banks compete. Bankers will be taking a fresh look at ATM deployment, considering biometrics for customer self-service (e.g., accessing the safe deposit box area via palm scan), use of enhanced kiosks, and better use of multimedia to subtly advertise bank products and services and to entertain people standing in line.

3. Changing Times for IT Risk Management Call for New Budget Items

Bank budgets must be revised to reflect the reality of today’s regulatory and technology environment. New budget items are being added for IT audits, network vulnerability assessments, managed security services, policy development, risk assessments and other IT risk management issues. In 2003-04 most banks didn’t budget for such items. Oversight of IT has become wider in scope and more frequent, making banks more secure but at a cost.

4. Consolidation of Technology Providers Makes Due Diligence Imperative

Bankers are learning that salespeople move on and companies change names, making the due diligence process all the more important when choosing a technology provider. Contracts are being negotiated more fervently than ever with the understanding that the players could change due to mergers and acquisitions and the bank must be able to live with the consequences. There will be more escape clauses for mergers, acquisitions, and the “sunsetting” of technology. Bankers now realize that few companies survive the long haul. Case in point, from 1917 to 1987, only 39 members of the Forbes 100 survived; of those, 37 underperformed the market. The two that outperformed were GE and Kodak.

Additionally, regulators want to see documented due diligence and better vendor management. Expect bankers to take a structured approach to system selection, documenting the process to justify decisions and managing technology provider relationships more closely.

5. Hardware Becomes a Commodity

It’s not 1999 anymore. Moore’s Law remains applicable as hardware continues to become more powerful at less cost. Some technology providers have succumbed to this fact and now view hardware as a commodity item priced accordingly. Others are having a hard time giving up this revenue stream and still price their hardware platform arbitrarily and exorbitantly. Bankers doing their homework can enjoy some big savings.

As storage needs increase due to imaging, data warehouses and the like, your vocabulary will expand with new terms such as petabyte (1,000 terabytes) and exabyte (one billion gigabytes). Hardware may be a commodity but demand for storage and better data management strategies will keep those hardware providers that adapt healthy. More data to manage will lead to the “Google-

ization” of bank networks making the Windows Explorer model obsolete for retrieving files.

6. Community Banks Will Continue to Thrive and Grow

Community banks are alive and well. Expect the latest round of merger and acquisition activity to spawn another de novo explosion. De novo banks are starting with a clean technology slate and can quickly offer most of the same technology as their big bank competitors with much less bureaucracy and much more personal service. Market forces should allow community banks to thrive.

Community bank IT strategies will continue to differ slightly from large bank strategies. Community banks are more nimble at implementing technology but large banks have the high transaction volumes to better cost justify technology projects and enjoy true economies of scale.

7. Personal Productivity Will Be Expected and Measured

Bankers are expecting more from their people. “Produce or perish” seems to be the harsh reality that faces bank employees. As banks strive to be more efficient and contain costs, those employees not contributing are at risk. Bankers are trying to find the right blend of people and technology to outpace their competitors. Expect increased measurement of personal productivity where bankers can compare their productivity to peer much in the same way they have compared financial performance. There will be scorecards for each office to monitor productivity and performance. By carefully monitoring staffing needs, banks will do a better job of matching personnel supply with demand.

8. Managed Security Services Become Ubiquitous

As more bankers attempt to tackle security issues in a piecemeal fashion, they will discover that an enterprise-wide approach is required. Purchasing network security solutions is very easy, but implementing and maintaining network security solutions is quite difficult. Bankers will also discover that staffing network security 24/7 is not feasible for the typical bank, thus managed security services providers (MSSPs) will provide the around-the-clock monitoring necessary for quick response and peace of mind. Vulnerability scanning, intrusion detection/prevention, firewall monitoring, and “malware” (malicious software protection) are a few of the services bankers will rely on third parties to provide.

9. Payments System Continues to Evolve with Check Volumes Declining and Check 21 Slowly Gaining Traction

Check 21 became law on October 28, 2004, a day that came and went without much fanfare. While Check 21 didn’t carry a huge impact in 2004, it will

clearly increase check electronification and has started a domino effect that will dramatically change the check clearing process.

Technology will take a backseat to business process re-engineering as banks seek better methods to process checks such as least-cost routing. Imaging technology will be a key component, and bankers will evaluate network infrastructure opportunities and increased integration of imaging systems with the core. Image exchange remains voluntary. Larger players will benefit most from this trend. Standards are going to have to be set.

Bankers will struggle with keeping physical transportation of checks alive until this method is no longer needed. Accordingly, the per-unit costs associated with the physical transportation of checks will increase as check volumes decrease.

10. Government Will Get Bigger; the Compliance Burden Will Continue to Increase

Bankers are facing tough challenges as they attempt to balance security and compliance with consumer demand for more open environments and multiple delivery channels. Regulator satisfaction is competing with customer satisfaction. Customers want their banking services anywhere, anytime but safe and secure. Regulators want more controls, better corporate governance and documentation.

Key IT compliance issues facing bankers in 2005 include:

- Section 404 of the Sarbanes Oxley Act (for publicly-traded banks).
- USA Patriot Act (anti-money laundering).
- Gramm Leach Bliley Act (risk assessment, policies)
- More stringent IT examinations (wider scope, more frequent)
- An enterprise-wide approach to network security (strategically planning for security)

Summary

New regulations, security threats, cost containment concerns, and productivity pressures will be offset by check processing efficiency gains, electronic transaction growth, community bank success, online activity increases, multi-channel integration, improved retail delivery and better IT risk management. 2005 begins with new challenges but bankers now have the technology to sustain competitive advantage and succeed in today's rapidly changing banking environment.

Growing Business with Customer Self-Service and EBPP



Richard K. Crone
Director
Edgar, Dunn & Company

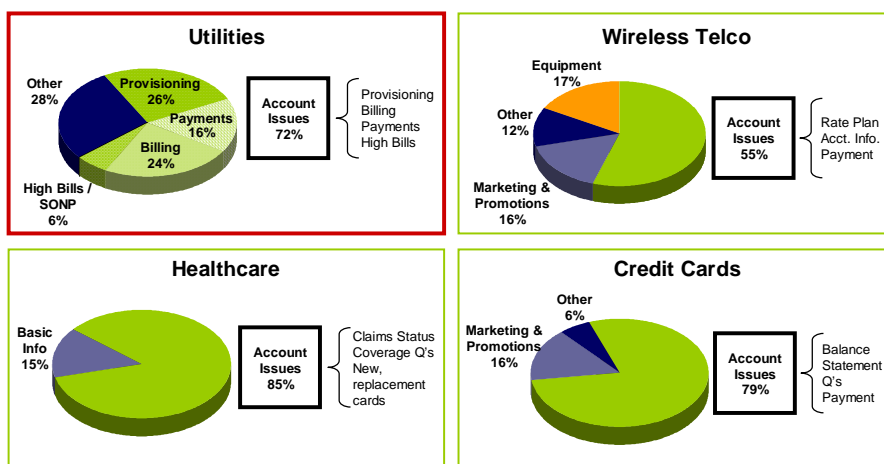
Today, recurring billers, including financial institutions, utilities and telecommunications companies, are increasingly faced with rising competition, mounting fixed costs and numerous other market factors affecting profitability. Some industries, such as utilities, operate within a highly regulated and commoditized market environment where achieving measurable competitive advantage poses a serious challenge. One of the few ways recurring billers of any stripe can differentiate themselves lies in providing truly superior customer service.

To meet current demands of both customers and recurring billers, Customer Self-Service (CSS) and Electronic Bill Payment/Presentment (EBPP) have recently emerged as a strategic “silver bullet.” These innovative payment systems provide new levels of customer service and operational efficiencies that translate into significant cost savings and long term earnings for the biller. Gartner Group Research reports that the top 200 U.S. utility companies could each save at least \$10 million annually by implementing customer self-service offerings through their web- and telephone-based interactive response units.

The last few years have seen explosive growth in consumer adoption and use of biller-direct Internet sites. The catalyst for this phenomenal growth has been customer self-service and electronic payment features offered by many billers through Online Account Management. Currently up to 100,000 consumers per day enroll directly with billers to access their statements, initiate electronic payments and manage their accounts online. Recent market studies show that nearly 75 percent of all customer service requests are related to billing and payments. Electronic bill payments are projected to grow five times faster at biller web sites than at banks and other sites that enable online payments.

For large recurring billers, most calls into the Contact Center deal with account, billing and payment Issues

% of Calls to Contact Centers



Source: edocs, Edgar, Dunn & Company and selected industry firms

Offering CSS and EBPP to customers is a winning strategy because these innovations help recurring billers differentiate their brands, streamline costly billing operations by deflecting call center volume, and dramatically reduce payment float and processing costs. CSS and EBPP also impacts earnings, too, by enabling earlier payment collection, opening opportunities for new fee offerings, and promoting the cross-selling of existing and related services.

Online Access –The Disruptive Technology for Recurring Payments

The ability to adopt CSS and EBPP solutions is made possible in large part by the Internet’s facility to link billers and customers directly to one another in real-time. As a “disruptive technology,” the impact and benefits are not small or incremental, but are significant and responsible for driving a considerably different way of doing business.

Online access to financial services accounts and electronic bill payment are the most popular and fastest growing applications on the Internet today. With little material effort on their part, many recurring billers process 5 to 25 percent of their bills over the Internet. Customers using biller-direct Internet payment services prefer the convenience and control it offers. Half of those reporting say they value “net payments” for providing last minute payment options, assuring that their payments arrive in time, and helping them avoid late fees, interrupted service, reconnection charges and a weakened credit record. Since most customer service calls relate to billing and payment, CSS addresses these inquiries while reducing or eliminating the principal call volume load of a typical contact center.

As a rule, 80 percent or more of the calls to a biller's contact center can be resolved with online access to accounts. Migrating customer service phone calls to a Web self-service channel can save the standard recurring biller as much as \$7 per call — a 59 percent cost reduction on average for a standard call. In some areas, the benefit is significantly greater. For example, automating invoice disputes can save recurring billers \$25 per incident, almost half of the average \$55 per incident for manual resolution. Automation also accelerates collections and reduces receivables financing costs.

Adoption Curve & Critical Success Factors for Customer Self Service (CSS)

A successful CSS program is one with the highest possible usage rate. To achieve this, a company must commit to proactively “manage” CSS adoption. Simply offering customers service online or via the phone through an IVR (interactive voice recognition) won’t guarantee automatic adoption. A biller must invest in a robust, state of the art, second-generation CSS infrastructure, and promote its CSS functionality to customers in the early stages.

Best-in-class recurring billers have demonstrated that adoption can be managed and optimized as a controllable variable. Successful CSS programs require the successful execution of three elements: Strategy, Tactics and Platform. Without all three, adoption and a successful return on the investment will take much longer to achieve. With all three elements in place, recurring billers can enjoy adoption on par with best-in-class CSS billers.

- **Strategy:** Different industries require different Customer Self-Service strategies for success. For example, a B2B telecommunications company’s implementation may require a highly interactive, analytical web presence with minimal IVR. However, B2C billers might require a multi-channel, self-servicing platform that integrates online, IVR, and Customer Service Representatives (CSR) in order to simplify all the customer service interactions (presentment, analysis, payment, provisioning) for greater efficiency.
- **Tactics:** The right strategy is meaningless without appropriate supporting tactics. These include not only marketing and awareness campaigns, but also business processes, incentives, disincentives, and site design and navigation. Customers must be aware of the self-service capabilities and must be motivated to use them. Proven techniques to promote adoption range from advertising to business processes that integrate the different channels (IVR, CSR, online) to work together. For example, the IVR channel can drive customers to the biller’s relevant web site, or the CSR channel can be optimized to enroll customers in automatic or “semi-automatic” electronic payments that the customer controls. Employing an integrated, multi-channel strategy allows the biller to maximize adoption by placing customers in their preferred self-service channel as rapidly as possible. Additionally, it ensures that customers will continue to serve themselves over time, resulting in long-term satisfaction, greater customer loyalty and an increased ROI.

- **Platform:** Strategy and tactics must be supported by the right self-service platform. Typically, different channels on *different* platforms cannot be combined to maximize adoption. A robust, *shared* platform enables the integration of back end systems for support of various self-service processes. It also has the capability to communicate the most appropriate educational or persuasive messages to target customers based on demographic or account level information. The glue that holds all this together is the registration and use of electronic payment and the option for customers to consummate the transaction online.

Most recurring billers, concerned about new technology costs, are likely to find that they already have many of the required elements in place. An inventory of current capabilities mapped against CSS infrastructure requirements often reveals that little additional technology is actually needed. Often the only additional piece needed is an integrated customer database or an upgrade to second-generation CSS platforms.

Paper Turn Off – The Holy Grail of Payment Processing

To reach the holy grail of “paper turn off,” or PTO, we’re seeing increasing efforts to encourage customers to register for and use electronic bill payment systems. PTO cannot occur without electronic payment registration, and the easiest way to enroll for electronic payment is directly with the biller.

The annual savings of \$5-10 million from PTO typically is more than enough to justify the technology investment and support cost. Most of us have experienced in a self-service gas station an electronic payment alternative and the paper turn-off (PTO) option. According to the National Association of Convenience Stores, more than 30 percent of consumers don’t print the paper receipt after paying at the pump. Imagine the cost savings for a utility if 30 percent of its customers relied on CSS and didn’t print their paper statements.

In summary, effective CSS and EPPB can improve biller profitability evidenced by the following:

Impact on Revenue

- Reduction in days outstanding
- Differentiation of level of service
- Increased customer satisfaction, improved customer retention
- Affiliated marketing activities, including cross-selling and up-selling existing services and products, and cross-selling related products from other companies

Impact on Cost

- Reduction of account management cost
- Deflection of calls for billing inquiries, payments and service orders

- Reduction of payment processing costs (e.g., reduction in mail received from customers, decreased time removing payments from envelopes and sorting by payment type, and reduction in workstation processing, data entry, reject handling, etc.)
- Reduction/elimination of paper statements
- Elimination of major inefficiencies and constraints across each pathway within the entire billing and payment process

Strategic Impact of CSS for Recurring Billers and Consumers

In the long run, CSS enables consumers to be better informed and helps them make choices tailored to their individual needs and lifestyles. By migrating to CSS and EBPP, recurring billers can more easily provide consumers with control and convenience in monitoring their consumption and usage patterns. The real-time consumer data generated by CSS has significant strategic implications on production levels, resource planning and infrastructure outlays that can result in substantial company savings and earnings. Access to real-time consumer data can potentially better match supply and demand across shorter time intervals, leading to lower cost per unit of consumption, increased operational efficiencies and enhanced financial returns.

Best-in-class recurring billers, such as banks, are realizing that the tangible, immediate cost reduction benefits of CSS and EBPP adoption is only the tip of the iceberg. Beyond billing and payment, CSS and EBPP is a strategic initiative that can impact a company's ability to manage fixed cost variables, including procuring or generating a product or service, and infrastructure outlays for service delivery, labor costs, and customer-facing activities. Implementing customer self-service offers management more substantive opportunities for improvement than any other business variable—clearly, a strategic silver bullet worth the investment.

Image is Everything



James Van Dyke
Founder and Principal Analyst
Javelin Strategy & Research

A few years ago, online finance was all about access. These days, it's becoming more about control and safety. Over the past 12 months, online households have gravitated to increased mobility of funds; easy, central access to imaged checks and consolidated statements; and have placed increased importance in security factors. Among an online populace now 75 percent comprised of tenured (veteran) Internet users, fear rather than lack of interest is keeping the vast majority from banking online. Consider that in 2003 to 2004, the largest movements to online banking took place for capabilities available at only a fraction of all Web sites. The significance of the shifting consumer tastes is understated by the data, since universal availability of check imaging, FI-to-FI transfers and consolidated statements will certainly greatly advance in overall popularity and use in the remainder of 2005 and beyond.

Between 2003 and 2004, online households continued to activate the simpler or frequent aspects of online finance, such as banking and bill payment and presentment, while avoiding more difficult and static capabilities, such as aggregation, insurance, lending and Quicken or Money. Meanwhile, households decreased their reliance on automated telephone systems. The significance of the rapid and escalating use of several newer capabilities is even more dramatic when you consider that many sites do not offer the ability to view check images, see several billing statements at one site and transfer funds from one bank to another.

Person-to-Person payments users also significantly increased their number, even though the number of online auction users (who comprise most P-to-P payments users) expanded even more. Investment services – a business line that enjoyed robust growth in the early years of online finance – is unique in that its dampened use reflects overall available returns in that sector. Telephone banking usage has declined as consumers increasingly turn to the convenience and capabilities of Internet finance, yet it still remains an indispensable part of a financial institution's access options. While the use of

financial alerts is still low, Javelin predicts alerts – along with viewing consolidated statements and check images – will head the list in our sequel to be published in mid-2005.

Concern about identity fraud combined with ongoing provider consolidation cause consumers to place increased value in security and stability. (Interest rates and convenience top the list of evergreen reasons that consumers choose new providers, but as they represent no significant change, they don't make our chart.) We've long advised providers to tout services that deliver peace of mind, and this advice has never been as important as it is today. Ingredients such as longevity, branch/customer service availability and site layout/usability are all part of the recipe for building trust. Javelin predicts strong relationships in the future will largely be determined through offerings that account holders associate with reduced risk of fraud. Those services include online account management to eliminate paper, convenient and secure archiving and retrieval, and centralized statement viewing and account alerts for more convenient account monitoring. Guarantees against fraud (or lack of payment delivery for any other reason) should also be touted. While many understand that online finance is all about trust and convenience, a fewer number realize that trust is the foundation on which convenience can be offered.

Consumer interest in viewing biller statements at individual biller sites lost significant ground to that of consolidated sites (such as banks, credit unions and portals), while the number of consumers that lack any interest in viewing and paying bills online has dipped sharply. Convenience can be the only universal bait to the consolidator model, as consolidator sites have a potential disadvantage in fee-based bill pay and consumers are unaware of the potential identity fraud benefits of consolidated statement viewing. Had "wallets" or aggregation technologies lived up to their promises, the current high penetration of direct biller sites might have been the death knell for consolidator sites, as each of these applications had the ability to reduce convenience barriers to consumer use of billing at individual sites.

Consumer preference for consolidated statement viewing has always overshadowed that of individual billing sites, yet actual adoption of consolidated viewing lags "biller-direct" by a factor of more than two-to-one (59 percent to 25 percent). So why do consumers consistently and overwhelmingly indicate a preference to view and pay billing statements centrally, but then do so disparately? The answer is simple: lack of content and services, along with (to a decreasing degree) the fees charged. However, maturing online users more and more will look for convenience, increased content and advanced services at central sites. Consumers want the ability to simply find and add new billers, make just in time payments and easily use centralized alerts, archival and retrieval services (because finance managers might fear fraudsters no more or less than their own inability to manage their finances without the aid of paper records). To disconnect consumers from preexisting direct biller relationships, central sites will have to develop simple and secure capabilities for transferring

online statements from delivery to biller sites to central sites. And, as consumer awareness of the positive link between real time statement details and fraud detection rises, central sites will also need to add the capability to refresh account details regularly. Meanwhile, billers that hope to retain direct customer relationships can counter with similar advanced functions of their own, providing information and functionality superior to that provided at consolidator sites.

Summary

Online financial applications have changed significantly over the past 12 months, at times sparking the adoption of underutilized capabilities like bill payment or consolidated presentment, and at other times stagnating or even eroding them, as with personal finance software or telephone banking. To realize further growth throughout the remainder of 2005, online executives must now boldly address customers' fears, while adding fast-growing capabilities, such as imaged checks or consolidated statements, before competitors make them a point of differentiation. Meanwhile, the growth for insurance and other financial sectors is bound to be limited because the industry is not structured for direct Internet sales or support. Longer term, we predict steady increase in basic, consolidated and control-oriented services offered through established and known providers at the expense of individual sites or portals like AOL and Yahoo!.

The Business Value of a Modern IT Architecture



Jake Maan de Kok
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Much has been written recently about the increased emphasis on the consumer-banking segment among retail banks. As banks compete for this business in the increasingly competitive financial services industry, they are planning to make significant financial investments, particularly in technology. Datamonitor reports that the U.S. retail banking industry will increase information technology (IT) investment at an annual rate of 4.1 percent, reaching \$37.8 billion in 2006. However, some banks will likely achieve more with their investments than others, because their IT departments have moved ahead of the competition in providing a modern architectural base for building the advanced systems required to achieve their goals.

The intent of this increased spending is to raise revenues, decrease expenses and increase customer satisfaction. For the retail banking line of business, this involves selling new products in a customer centric fashion through a highly effective retail delivery network, while providing high levels of customer service at low cost. Banks want to be able to react quickly to market forces with the flexibility to introduce new products in a timely manner and to access consistent customer data at the place and time of customer contact. In addition, these institutions want to give personnel the tools to be successful in a sales role and to be more effective and more efficient.

To accomplish this transition, the applications available to customer contact personnel are expanding from those traditionally available. In addition to adding new products, the environment is being extended by adding capabilities such as enhanced customer information management, new capabilities for profiling customers, and facilities for measuring the effectiveness of sales and marketing. Additionally, the traditional task-specific desktop that has been available to these employees is being extended with the same enterprise communications and services common to all company employees. Such capabilities as e-mail, access to human resources applications, online training

and team productivity facilitation are being included or considered. The industry has a general consensus on these points.

There is also a general consensus that in order to execute on this strategy the IT organization needs to provide some key enhancements. The IT organizations realize the need to provide better, more integrated customer data than is provided today, along with better integration to core application systems and integrated retail delivery systems.

What is not generally discussed in detail between the IT department and the retail banking line of business is the impact the bank's architecture can have on the ability to deliver improvements in infrastructure and business functions. The executive vice president of Retail Banking has no desire to get deeply into Web application servers, message brokers and converged IP networks. It can be very helpful to both sides if there is agreement at a high level on where the bank is and where it is going in terms of architecture. While the implementation of the architecture involves many technical issues, there are very real business rewards and risks that flow from having an effective or ineffective architectural base in place. It is especially important that the retail banking line of business see the value in these infrastructure improvements because the investments required can be substantial. One large Canadian financial institution reportedly spent \$260 million on a branch renewal project, with \$180 million going to infrastructure and \$80 million to applications.

For the IT organization, providing these advanced capabilities is a real challenge, because every large U.S. bank operates with a basic IT architecture that is the accumulation of 30 years of relatively independent decisions. The typical bank has a series of back-end systems (deposits, loans, credit cards, etc.) chosen independently of one another, and prior to the advent of the on-line front-end systems relied upon today. Over time, decisions were made on front-end systems for teller, platform, ATMs, call centers, internet banking etc., and each front-end systems was integrated to each back-end system. The result is a familiar architecture of siloed application systems that is represented in generic form in Figure 1.

Yesterday's Infrastructure

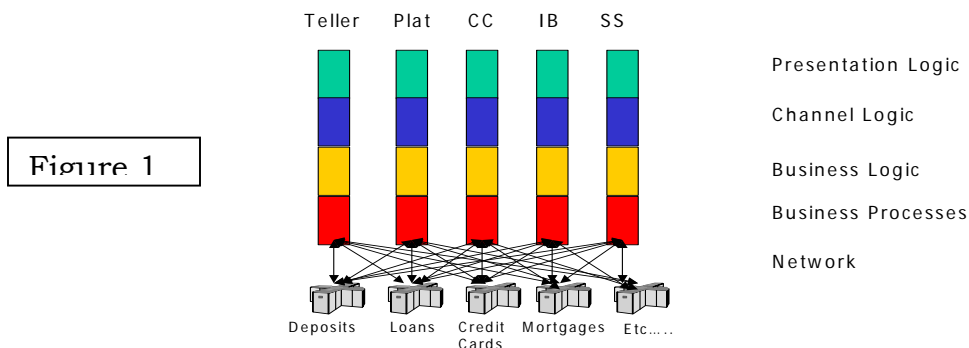


Figure 1

The most prominent attribute of this architecture is duplication, and, in today's environment, duplication is a sin. Every layer of the architecture is duplicated in each application silo. This means that every time a new function is needed, three or four applications need to be changed. Every regulatory change also has the potential to cause modifications to several channel applications. Since each front-end application was typically a separate decision at a unique point in time, it is possible each will involve a different language, perhaps a different operating system and different messaging conventions. For the IT department this implies increased expense and skills dependence. Duplication is the primary reason it is not uncommon for 60-70 percent of a bank's development budget to be spent on maintenance of existing functions rather than in building new functions. For the retail banking line of business, this results in increased application backlogs, difficulty in introducing new products, lowered customer satisfaction and lowered productivity.

To execute on a strategy of being able to introduce new products quickly and provide a customer centric experience, banks are beginning to evolve from yesterday's architecture toward a modern architecture that avoids duplication. A generic version of such an architecture is illustrated in Figure 2.

Tomorrow's Infrastructure

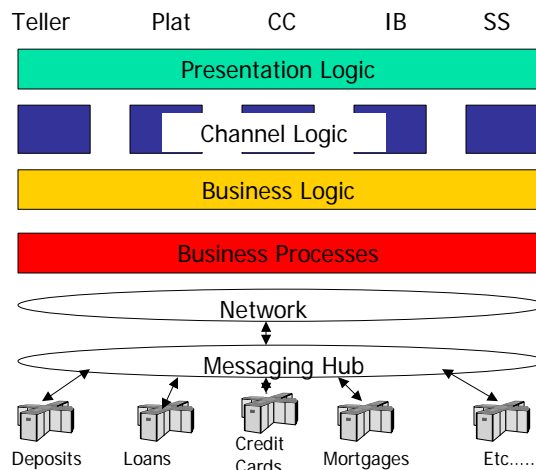


Figure 2

The most prominent attribute of this architecture is sharing. In today's environment sharing is a virtue. The modern architecture builds on shared layers of functionality that are used by each channel application. Thus, a new application is built once and reused by each channel. Similarly, the logic for a funds transfer would be built once in the business logic layer of the architecture and used by the branch personnel, call center agents, the Internet banking user and at the ATM. The business process rules for loan application

processing would be built once, in the business process layer. Should the logic change, the change can be made in this one place, and all of the channel applications will effectively be updated. For the IT department, this means a greatly reduced maintenance burden, better skills utilization and that a much greater part of their resources can be devoted to delivering additional business function. To the retail banking organization, it means greatly increased flexibility to introduce new products, reduced application backlogs and much better information on the customer. No banks are far enough along in the process of implementing this modern architecture to have real life numbers available. Logic, however, suggests that if each new function can be built once, rather than three or four times, the result would be a substantial increase in the amount of function that can be provided for a given amount of development funding. And if that function can be maintained in one place rather than multiple places, a substantial dent could be put in the 60-70 percent of development dollars that go to maintenance.

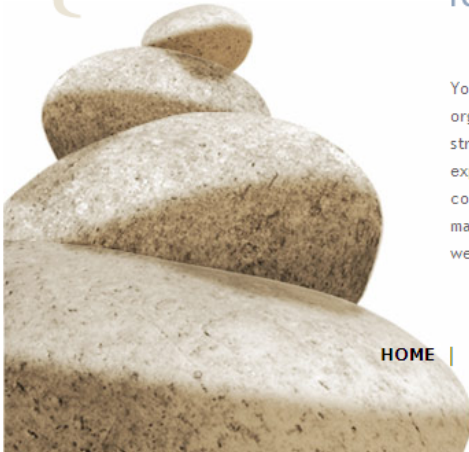
Recognizing the need for such a rational architecture, most vendors who provide delivery channel applications are enhancing their offerings to provide such an environment. Others will no doubt join this group over time.

Most large U.S. banks have begun the task of transitioning from the hodgepodge of systems that have grown up over the last 30 years to a modern, logical architecture that will support the role banks want their delivery systems to play in the twenty-first century. The journey won't be easy, and it will involve a good deal of investment. When the vision is achieved, however, the rewards will be enormous. The bank will be much more nimble than it is today. It will have the ability to introduce and sell new products, add new channels, service customers and increase productivity in ways that cannot be done today. And we will all wonder how we survived until then.

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