

From banks to banking: The on demand journey



An IBM Institute for Business Value executive brief

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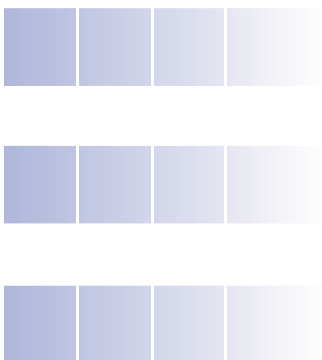
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From banks to banking: The on demand journey

With recent value creation strategies stalled, banks are undertaking fundamental changes to their business structures; meanwhile, the industry itself is taking on a new shape. As banking institutions reconstruct and the industry itself deconstructs, these two paths will naturally converge – on the road to an on demand banking environment.

The latest financial reports are upbeat, but telecom workers remain jittery. It's 2006, but, for many, the memories of the corporate write-offs and layoffs that marred the start of this decade are still too vivid. Fortunately, your bank is prepared to help. With assistance from best-in-class risk modelers in the US, France and Finland, you've come up with a risk product that can protect workers in the volatile telecom industry from a sudden loss of wages resulting from corporate layoffs. Assembling the product with help from other financial institutions in each geographic region helped distribute the risk and allowed you to customize your offering for each locale. With access to both proprietary and external insights, you know the telecom industry's cycles, you know which workers are likely targets, you know how long they'll probably need supplemental income, you know how to appropriately price the risk – and you've developed a product that addresses the workers' needs as well as your own.

To better reach targeted regions where high concentrations of telecom employees live and work, you're expanding the distribution relationship that you already established with various postal services for bill payment offerings. Through private kiosks, customers can initiate an automated application, review and approval process for your new risk product – mailing packages, paying their bills and insuring their incomes, all on a single trip to the post office. It's convenient for your customers and economical for you – since the distributors involved charge based on usage. Since the product's launch, uptake has been phenomenal. Your telecom-employed customers have gained some much-needed peace of mind, and you've uncorked a new revenue stream. Best of all, as you helped your customers protect themselves, you were actually protecting your own asset base. By signing up nearly eighty percent of your existing customers who have multiple loans, which would be at risk in a job loss situation, you mitigated your own risk exposure significantly. So, how were you able to respond to market needs and improve resilience at the same time? You've learned the art of operating on demand.



Path full of obstacles

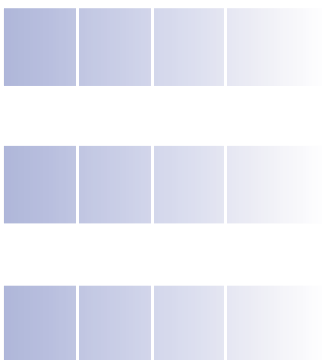
Throughout the 1990's, banks relied on three primary strategies to create shareholder value¹:

- Risk reduction – securitizing a greater number of the loans they originated, as well as other assets sitting on their books
- Revenue diversification – expanding their revenue base through additional sources of non-interest income
- Consolidation – capturing economies of scale and scope through acquisitions and mergers.

Although initial results were impressive, the returns from these strategies have now flattened – and a few undesirable consequences have emerged. Alleviating risk through the sale or securitization of assets had the unpleasant side effect of putting even more distance between banks and their customers. Further growth in fee-related income through the introduction of service charges worked against the need to cultivate customer loyalty. And a decade full of mergers and acquisitions left banks with organizational, process and system complexity, which placed enormous strain on operational efficiency and financial performance.

With all this change, banks are still largely operating with the same traditional business structures where distribution occurs by product silo and operations are biased toward internally manufactured products. Within this structure, even leading banks can't seem to squeeze out any more cost, and customers generally see very little or no differentiation among banks. Given their financial challenges, banks cannot afford to have capabilities duplicated across product silos, with each product operating its own processes, systems and product-specific channels. And although they offered increased efficiency, vertically integrated supply chains limited customer choice – leaving firms with an undifferentiated value proposition and lower overall customer wallet share.

Given these dire straits, it's no surprise that banks are moving away from the confines of their historical business structures. But with value continuously shifting to different parts of the value chain, many banks are struggling, unsure which areas of their business matter most and uncertain where they should be headed.



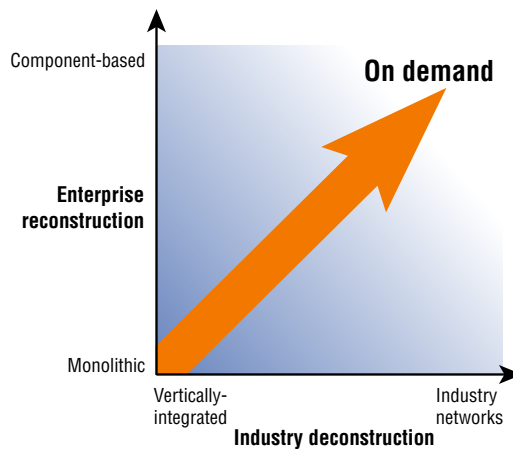
New direction needed

With the dynamics of the future so unclear, it only makes it more apparent that banks will need:

- Greater **focus** on what differentiates them from the competition, less attention – and spending – on commodity-like functions
- Heightened **responsiveness** to ongoing changes in the marketplace, more empowered customers and increasingly complex demands from regulators and stakeholders
- **Variable** cost structures that allow banks to accommodate fluctuations in market demand and product preferences while improving financial position through lower cost structures
- Improved **resilience** to counteract increased internal and external uncertainty and marketplace volatility – whether protecting your business from shocks such as natural disasters, privacy and security threats and geopolitical events or addressing everyday challenges like business expansion and credit risk.

The question is: How will banks reach that enviable position? Two primary paths seem clear – one involves the industry as a whole and the other is traveled by individual firms. As an industry, banking is moving away from a set of independent, vertically integrated institutions toward a network of affiliated financial institutions. At the same time, individual enterprises are reconstructing – breaking product silos into small, encapsulated business components that can be shared across the enterprise (see Figure 1).

Figure 1. Paths of progression moving banks toward on demand.



In fact, the confluence of these two paths is propelling banks toward an on demand operating environment where a bank's business structure and supporting business processes become flexible enough to respond rapidly to virtually any customer demand, market opportunity or external threat.

Source: IBM Institute for Business Value analysis.

The industry becomes more networked

Although product and service silos still have a stronghold within most financial services institutions, the monolithic view of the enterprise is fading, as is vertical integration. Whether of their own volition or spurred by new players arriving on the scene with significantly improved value propositions for particular parts of the value chain, companies are beginning to specialize. They are selecting a more specific industry role – manufacturing, distribution, risk management or processing – that suits their strengths and turning externally (or internally to other business units besides their own) to supplement weak capabilities.

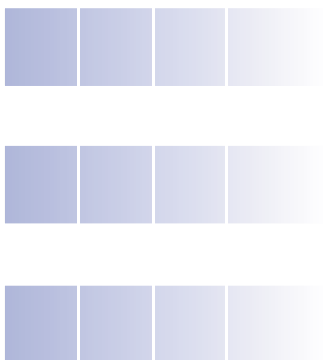
In most financial services industries, the shift from vertical integration to a networked structure usually begins with distribution as firms seek additional outlets for their manufactured product. Scale-based processors emerge quickly too, assuming responsibility for operations that other firms are choosing to relinquish.

Unfortunately, ill-defined standards and inadequate linkages between enterprises often hamper industry restructuring. Processing standards and interfaces between companies are developed in an ad hoc, one-off fashion, making it expensive to establish collaborative relationships and even more costly to switch providers.

In the mortgage industry, specialization is now the norm. Most banks that are still in this business concentrate on origination and servicing, while other providers assume responsibility for the remaining activities – credit risk management and interest rate risk management. This separation has, however, come at a price. Intercompany communication remains cumbersome with fragmented processes, data moving between firms by fax and phone and manual reentry as each enterprise boundary is crossed.

As technology continues to progress, connectivity improves and standards emerge, the industry will have the wherewithal to become more and more networked. Since only a few large companies will be able to span the full range of products in a vertically integrated manner, most firms will focus exclusively on areas where they have comparative advantage. Distributors will own the customer interface, while specialists with deep product expertise will develop new products based on segment-specific customer insights that the

distributors provide. Companies will take advantage of scale efficiencies offered by selected processors – perhaps even tapping into low-cost labor pools overseas. Most critical of all, the customer benefits too. With access to best-of-breed products through a variety of distributors and improved customer service, customers are no longer forced to choose between seamless service and a superior product.



As additional businesses start to deconstruct and bank revenues shift, banks will need to leverage their biggest asset: their customer base. In order to do this, banks will have to revisit their current business structures, looking to capitalize on hidden efficiencies and leverage customer relationships across their enterprises.

The enterprise reconstructs

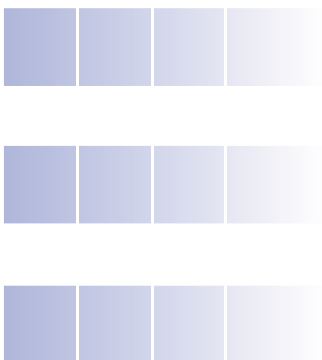
Unlike their limited influence over the structure of the industry itself, financial institutions have direct control over the evolution of their own organizations. In order to improve efficiency, banks are already beginning to break out of their product silos by identifying and sharing common enterprise processes such as procurement, human resource management and accounting. They are also beginning to appoint executives responsible for nurturing horizontal competencies such as distribution, manufacturing, risk and processing.

Banks are cobbling together an integrated view of the customer; however, channels are still predominately product-centric and management control remains within business units. With interdependent processes across competencies and business units, banks are struggling with overwhelming operational complexity. Connections among different areas of the enterprise tend to be static, inflexible and sometimes manual. Without adequate integration, the cost associated with the resulting organizational complexity can sometimes rise to the point where it offsets any benefits gained from shared processes.

A component is a group of cohesive business activities supported by the appropriate information systems, processes, organizational structure and performance measures. Each component serves a unique purpose and collaborates with other enterprise components, using common messaging standards, information systems and service agreements.

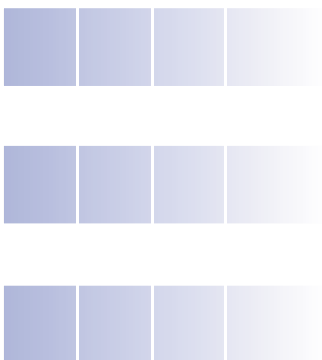
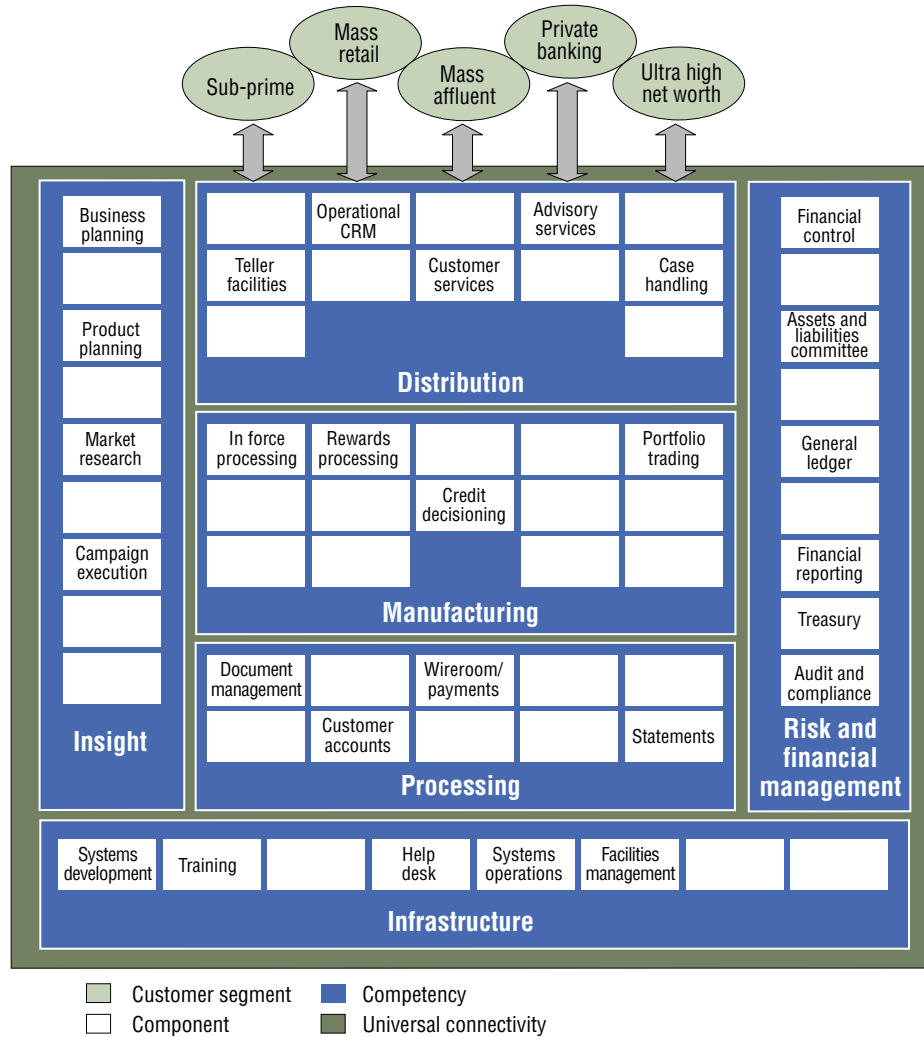
Moving into the future, banks will get relief. Advances in technology will ease the friction of enterprise reconfiguration, and financial institutions will become more comfortable operating across product lines. As collaborative capabilities expand, companies will be able to push the concept of shared processes past their initial competency-based structures to a much more granular business composition – one based on components.

Under a component-based structure, the business is divided into autonomous yet interdependent parts that can be optimized individually to produce greater value for the whole (see Figure 2). The granularity of the structure enables enterprises to



respond rapidly to change, reconfiguring as required. With this business design, competencies – composed of interlinked components – provide the general operational framework, not products. Distribution is tuned to targeted customer segments, offering a variety of products through customer-centric channels, all focused on increasing customer loyalty and share of wallet. Reuse of manufacturing capabilities increases, and processing operations achieve enterprisewide scale economies.

Figure 2. Illustrative example of typical components that comprise a standard retail bank.



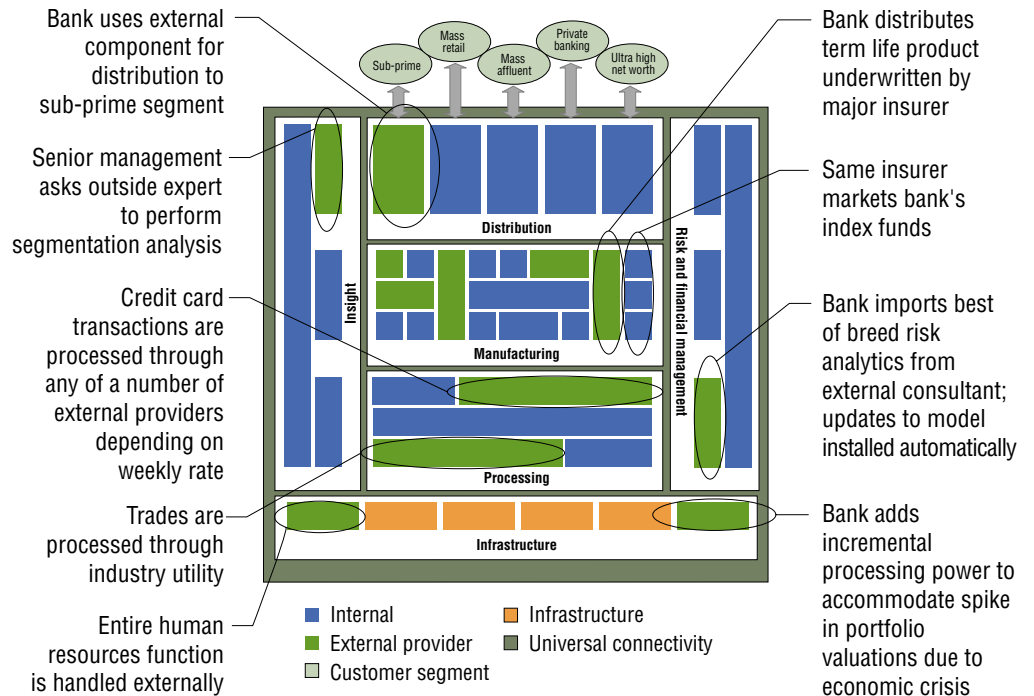
Source: IBM Institute for Business Value.

Paths converge in an on demand environment

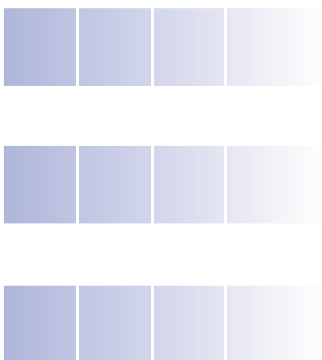
The flexibility to operate on demand comes as banks begin to restructure themselves into component-based businesses and learn to leverage best-in-class components from potential sources throughout the networked industry. The seamless connectivity and efficiencies previously confined within the four walls of the component-based business are combined with the specialization and scale made possible by a fully networked industry.

In an on demand operating environment, internal components compete on equal footing with external providers. And as the provision of a particular component becomes transparent, choice of provider will eventually migrate to the best value (see Figure 3).

Figure 3. As depicted by this example, banks will turn to external providers for an increasing number of components as they move toward an on demand environment.



Source: IBM Institute for Business Value analysis.

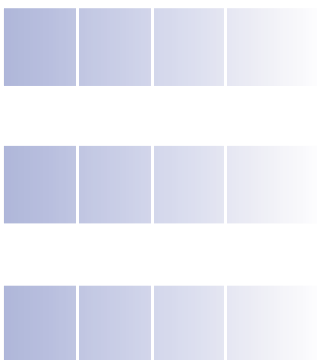


By taking advantage of best-in-class components, regardless of source, banks are better positioned to react quickly to opportunities and threats (see Figure 4).

Figure 4. The business environment shifts dramatically as banks move toward an on demand operating model.

	Traditional business environment	On demand environment
Distribution	<ul style="list-style-type: none"> • Channels developed separately and ‘bolted on’ to the business model; optimized for scale within silos • Disjointed marketing and fragmented data collection compromise customer relationships 	<ul style="list-style-type: none"> • Customers are targeted by segments, and products delivered accordingly • Seamless integration enables inter-channel data sharing, driving segment-based marketing initiatives
Manufacturing	<ul style="list-style-type: none"> • Silo-based product development inhibits input gathering from other business units • Offerings are developed to address needs as perceived by the business unit silo, not the enterprise 	<ul style="list-style-type: none"> • Products are sourced from most appropriate manufacturer within or outside the enterprise • Customized products are developed in a timely fashion to meet the needs of customer segments
Processing	<ul style="list-style-type: none"> • Rigid organizational boundaries restrict ability to collaborate with external entities • Operations located in higher-cost, developed countries, limiting scale economics 	<ul style="list-style-type: none"> • Transparent boundaries and interchangeable components allow enterprises to collaborate to respond to changing operating conditions • Location decisions exploit wage arbitrage opportunities
Insight	<ul style="list-style-type: none"> • Information collected and retained within organizational silos • Strategy developed at the business unit level 	<ul style="list-style-type: none"> • Information collected and shared cross-enterprise enables strategic analysis to be more responsive to changes in operating environment • Potential to use externally developed best-in-class analytics
Risk & financial management	<ul style="list-style-type: none"> • Risk management responsibilities are localized, within individual business and product units • Limited ability to disseminate risk data across the enterprise and out into the field 	<ul style="list-style-type: none"> • Enterprise takes a portfolio approach to managing risk across the entire organization • Realtime collection and dissemination of information, from and to the field, gives more accurate picture of risk and enables more effective risk management
Infrastructure	<ul style="list-style-type: none"> • Business silos maintain their own infrastructure that may not be compatible with other internal platforms • Certain business processes (e.g., HR) are shared across units but may not be best-in-class 	<ul style="list-style-type: none"> • Internal support services now compete with external providers, raising efficiency of entire firm • Standardized technical infrastructure fosters greater interoperability between all components, whether internal or external opportunities

Source: IBM Institute for Business Value analysis.



Banks that are positioning themselves for operating on demand share some common traits: focus, responsiveness, variability and resilience.

A **focused** bank:

- Concentrates investment on functions that differentiate it
- Targets those customers best suited to its operating model
- Accesses best-in-class capabilities and leverages scale efficiencies offered by partners
- Drives incremental revenue by taking its business component strengths to the marketplace

A **responsive** bank:

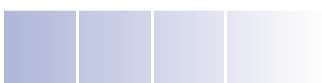
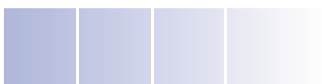
- Develops new products faster than its competitors
- Integrates new capabilities and acquisitions rapidly, achieving economic synergies sooner
- Customizes products to fit target customer needs, justifying a price premium
- Aggregates data across the organization, turning it into useful information
- Enables its staff to make fast, well-informed, customer-focused decisions

A **variable** bank:

- Builds its own component capacity to handle average load
- Supplements internal capabilities with outsourcing to achieve peak capacity
- Outsources non-differentiating components completely
- Shifts cost structure from predominantly fixed to predominantly variable

A **resilient** bank:

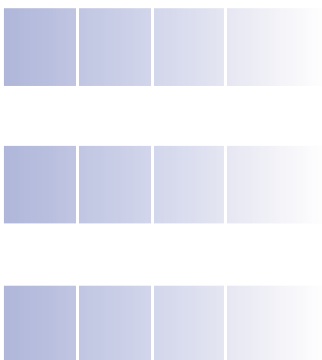
- Knows exposure to operational, market and credit risk in realtime
- Effectively distributes risk among strategic partners
- Reduces capital requirements through rigorous risk management
- Builds robust, “self-healing” organizational capabilities – both process and technology
- Recovers quickly from operational disruptions caused by unpredictable, external factors



On demand banks can offer their customers a superior value proposition as well. A focused bank provides distinctive products and services that customers value because it targets the right customers in the first place and concentrates on developing a deep understanding of that segment's needs. A responsive bank allows customers to interface with sales and service personnel seamlessly through multiple channels. Plus, it makes customers wait less, with reduced cycle time between customer contact and the bank's response. Thanks to its variable cost structure, an on demand bank can share its savings with customers through attractive rates and better-priced products.

To a large extent, technology advances are the key enablers that are making it possible for firms to operate in an on demand fashion. As IT becomes more open, integrated, virtualized and autonomic, it provides new ways of collaborating, eases business integration and reconfiguration and helps firms better manage the rising complexity of managing IT itself. To achieve this state of flexibility, a bank's IT infrastructure needs to be:

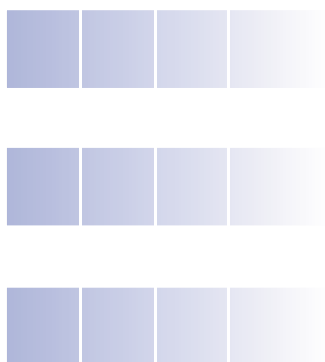
- **Based on open standards** – to simplify systems integration and adapt to technology changes rapidly
- **Integrated** – to facilitate transaction and process integration across the enterprise; allow realtime connectivity among partners, suppliers and customers; enable active data mining and decision support
- **Virtualized** – so that distributed computing resources are shared and managed as a single, virtual data center to increase the utilization of existing assets and lower IT costs
- **Autonomic** – with systems that can be managed remotely, have embedded privacy protection and security features and are capable of self-optimization, self-diagnosis and self-healing.



On demand operations can substantially impact bank's bottom line

Financial returns from moving toward on demand operations manifest themselves in numerous ways. Consider the economic impact even incremental steps toward on demand might offer:

- As they transition fixed costs to more variable structures, on demand banks have an opportunity to lower their cost-to-income ratios. The efficiency ratio of an average US bank falls in the 55 to 60 percent range², while some leading banks have reduced their ratios to less than 50 percent. What would the payback be if your institution could cut your cost-to-income ratio to best-in-class levels?
- Banks around the world tap into only a fraction of their customers' total revenue potential and often lose a notable percentage of their customer base annually. But, as an on demand bank focuses on the customer segments it is best equipped to serve and becomes more responsive to those customers' needs, customer defection will likely dissipate. How would your bank's revenue be impacted if you could double your consumer wallet-share penetration and reduce your attrition by half?
- In some banks, certain high-cost, high-frequency processes like loan origination or account opening may be replicated across as many as ten different consumer lines of business. These processes often operate with disparate systems and yield varying degrees of performance across business units. In contrast, an on demand bank would target common processes, striving to eliminate duplication and using its integrated, virtualized IT infrastructure to facilitate a shared business process. What savings might be generated if you could consolidate your top redundancy culprit into a single enterprisewide component?
- Whether through better utilization of existing assets, more self-managing features or utility computing, on demand banks are expected to spend less on routine IT support. U.S. banks are currently devoting around 90 percent of their IT budgets toward maintenance of existing systems³, leaving only 10 percent of their funds for new investments. What kind of differentiating technology could you invest in if your IT maintenance costs were reduced by 20 percent? And what if 40 to 50 percent of your remaining IT cost was variable and based on actual use?

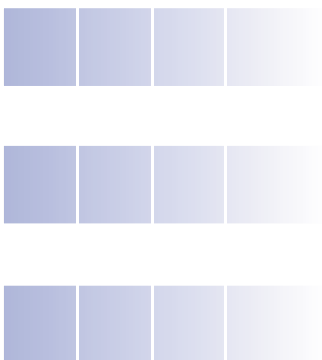


- Many retail banks experience significant challenges arising from employee turnover; in specific areas of the business, some banks replace roughly a third of their staff (usually call center representatives or tellers) annually. With revolving doors comes risk: staff giving out information that's invalid or unauthorized, failing to adhere to policy and procedure even falling prey to fraud. By specifically designing their businesses to be more resilient, on demand banks anticipate and are prepared to address a full range of operational risks, including those presented by staff attrition. How much would it be worth to your organization to substantially mitigate operational risks through rapid (even realtime) training of new employees and more automated compliance monitoring?
- Banks are large procurers of products and services in the marketplace. Often, significant cost is incurred in managing the procurement process, monitoring compliance and addressing exceptions. If you could – through on demand processes that encourage enterprisewide focus – reduce maverick spending, digitize most procurement processes and limit the number of vendors, what type of financial return might that afford to your bank?
- Given disparate marketing efforts and lack of customer information sharing across business units, a US bank could easily run up a tab of somewhere between US\$1,500 and US\$2,500 to acquire the same affluent customer, multiple times, across each line of business. In an on demand banking operation, where marketing efforts are coordinated based on a common view of the customer, banks should have to pay only once to acquire a customer. In your organization, if every new customer were acquired once by the enterprise – instead of by each individual business unit – what type of savings might that generate?

Moving toward on demand

Becoming an on demand bank is not a grand leap to a final destination point – it is a journey comprised of incremental, systematic steps toward an on demand environment. Many firms are already busy revamping their businesses processes and IT through actions such as relocating operations offshore, overhauling distribution networks and outsourcing IT. However, to date, these changes have been primarily cost-driven and frequently undertaken without a grand vision of how they all connect. Without strategic coordination, banks are unlikely to achieve the goals of becoming more responsive, focused, variable and resilient.

To move steadily toward an on demand banking environment, firms need a long-term plan that focuses first on reconstructing the enterprise and then helps position the company to respond to industry-level shifts and the opportunities they might present.



By restructuring their operating model into a component-based business structure, firms gain more flexibility to tap into best-in-class components that might be sitting outside organizational boundaries. Conversely, best-in-class components that are developed internally may present opportunities for realizing incremental revenue if offered to the marketplace at large.

Although a single firm has little direct control over the progression of banking toward a more networked industry structure, individual firms do play a role. New entrants with disruptive technologies or substantially improved value propositions are often the drivers of industrywide change. Maintaining awareness of such threats might even prompt a firm to introduce a game-changing trend itself. Because industry restructuring is occurring at different rates for different parts of the business, banks should evaluate threats and opportunities at the business unit level – attempting to pinpoint the specific areas of their business that are likely to be high-value creators as the industry evolves. Those components would then be prime targets for optimization and, potentially, differentiated market offerings.

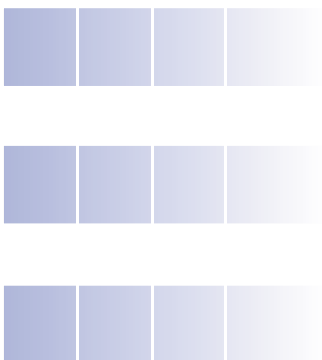
While technology has always played a part in supporting banks’ operating models, in an on demand environment, technology will become a strategic catalyst – creating an entirely new set of business possibilities. On demand banks will wield technology as a prime enabler of differentiation, efficiency and resilience.

The organization and culture of an on demand institution will be, by necessity, very different. To operate on demand, traditional barriers must give way to a new corporate mindset (see Figure 5). Managing this cultural transition will be a critical part of the on demand journey – and one that should not be underestimated.

Figure 5. On demand organizations exhibit a very different culture.

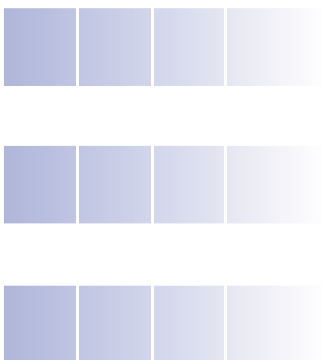
Traditional cultural barriers to change	Characteristics of an on demand organization
<ul style="list-style-type: none"> • Line of business silo mindset • Slow decision making processes and a lack of partnering capabilities • Inability to simultaneously nurture and control innovative ventures • Inflexible organizational structures and inflexible measures of success 	<ul style="list-style-type: none"> ✓ Networked, formally and informally, within and beyond organizational boundaries ✓ Ability to anticipate and respond rapidly to needs of customers and value network partners ✓ Individuality, diversity, creativity and change are embraced ✓ Self-organizing, re-shaping itself constantly as market demands dictate

Source: IBM Institute for Business Value analysis.



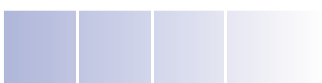
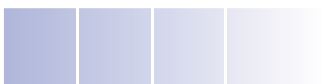
To chart their course toward an on demand banking environment, banks can start with three basic steps:

- 1. Establish “you are here” marker** – Assess how far your enterprise has moved beyond the confining business unit silo construct. Look at the existing processes, technology, resources and culture of each business unit to help gauge your progress toward a more component-based enterprise structure. At the same time, analyze the maturity profile of your business portfolio and its susceptibility to industry change. Plot how far along each of your primary product lines are in the industry deconstruction process. Determine which offerings may soon become obsolete or irrelevant – and simultaneously evaluate your firm’s ability to serve as a catalyst for further industry evolution. To avoid bias, it’s best to enlist a corporate (versus business unit) team to perform this assessment.
- 2. Restructure as a component-based business** – Begin by identifying the collection of activities that comprise each of the enterprise’s six competencies: manufacturing, distribution, processing, risk and financial management, insight and infrastructure. Group interrelated activities that serve a common purpose. As the component-based business structure emerges, you’ll also need to revise managerial tools, performance indicators and compensation schemes to facilitate change. As part of this transition, individual lines of business may have to abandon ownership of key processes, systems or resources – you’ll need to have the right incentives in place to encourage cooperation for the good of the whole. Garnering executive buy-in will be critical – as senior management support and focus will be required for the component-based vision to permeate the entire organization.
- 3. Pick prime on demand targets** – Examine each component, quantifying the potential economic value that could be unlocked by making that component operate on demand. Look for components whose transition to on demand will entail relatively low upfront investment and organizational risk and yet have the potential to yield tangible benefits. Use such a component as a beachhead from which to launch your on demand effort. Perhaps most importantly, given today’s economic environment, you’ll need to devise a self-funding mechanism to pay for your multistep journey. Some portion of the savings from each project should be reinvested in the next step that moves you closer to on demand.



A true on demand environment in banking will take time to develop as the industry and technology evolve; However, incremental benefits can be realized all along the way if banks learn to apply on demand concepts strategically and systematically. To discuss how our financial services consultants can help you plan and prepare for an on demand future, please contact us at iibv@us.ibm.com. To browse through other resources for business executives, we invite you to visit:

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The Financial Services Sector Team at the IBM Institute for Business Value created this executive brief based on their study entitled "From Banks to Banking: Operating in an on demand environment." To learn more about this study and how the movement toward an on demand operating environment may impact your business, please contact Ian Watson at iwatson@us.ibm.com.

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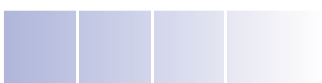
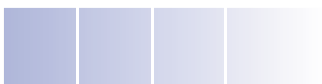
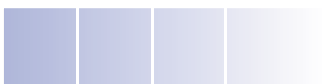
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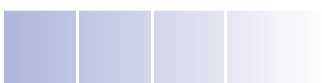
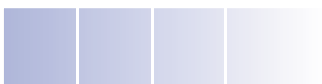
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