Modern Financial Services Simplified

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Modern Financial Services Overview

- Modern Technologies
- Modern Delivery Channels
- New Competitors
- Legal & Regulatory Considerations
- Business Considerations

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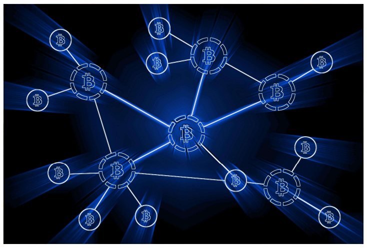

Digital Transformation in Financial Services

Digital Technologies Driving Change
Advancements like blockchain, AI, and digital assets are reshaping financial service delivery and consumption.

Embedded Finance and New Competitors
Fintechs and technology firms embed financial services into platforms, increasing competitive pressures on banks.

Regulatory Frameworks Impact
Emerging regulations like GENIUS and CLARITY Acts aim to clarify rules around digital assets and consumer protection.

Community Banks' Opportunities and Risks
Digital transformation offers efficiency and growth but poses risks like disintermediation and revenue decline for community banks.

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Digital Assets and Cryptocurrency

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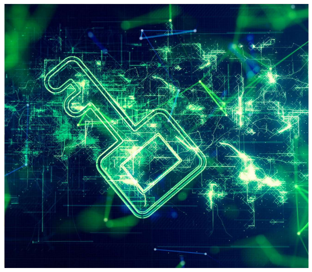

Digital Assets 101

Definition and Ownership

Digital assets are intangible assets that exist in digital form on blockchain with ownership secured by private keys, ensuring direct control.

Programmability and Automation

Smart contracts enable programmable conditions and automation, allowing frictionless asset transfers without intermediaries.

Types of Digital Assets

Includes cryptocurrencies, tokenized assets, stablecoins, and CBDCs, each with unique roles in the digital economy.

Impact on Financial Systems

Digital assets reshape value transfer speed, cost, and structure impacting payments, settlements, and regulatory landscape.

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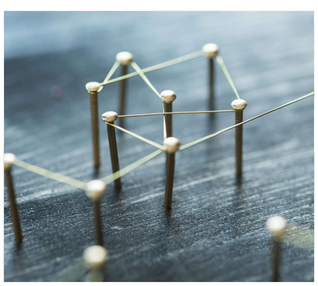

Cryptocurrency

Decentralized Blockchain Technology

Cryptocurrencies use open-source, immutable blockchains ensuring permanent and transparent transaction records accessible to all network participants.

Fungibility and Token Features

Cryptocurrencies are fungible digital tokens that may include governance rights, network access, or claims on digital and physical assets.

Volatility and Risk Factors

Lack of government backing and FDIC insurance causes high volatility and consumer protection concerns, limiting suitability for stable value storage.

Innovation in Finance

Cryptocurrencies enable advancements in payment systems, decentralized finance, and digital identity, pushing traditional banks to adapt and innovate.

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Blockchain Technology

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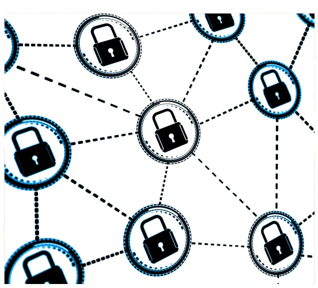

DLT and Blockchain Fundamentals

Decentralized Distributed Ledger

DLT stores identical ledger copies across multiple nodes without central authority, ensuring data synchronization.

Immutable Blockchain Structure

Blockchain links transactions into sequential blocks creating an unchangeable record for transparency and auditability.

Smart Contracts Automation

Smart contracts automate settlements and conditional payments by executing self-programmed code on the blockchain.

Financial Infrastructure Evolution

Blockchain unifies asset storage and exchange, reduces intermediaries and fees, enabling faster settlements.

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Stable Coins & Tokenized Deposits

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Stable Coins

Stable Coins

Stable coins are digital assets whose value is tied (or "pegged") to another asset, such as the US dollar, the euro or gold. Unlike cryptocurrencies, stable coins aim to keep their value close to a fixed amount (e.g. 1 stable coin = $1.00 USD)

Stable Coin Backing

There are several ways stable coins maintain their price, including fiat-backed (most common), crypto-backed or algorithmic.

Stable Coin Advantages

Stable coins combine the benefits of cryptocurrency transferability and a predictable, stable value. Common use cases include cross-border money transmission, trading cryptocurrencies, holding digital dollars on a blockchain and transaction consideration in DeFi applications.

Stable Coin Risk

Stable coins are not risk-free. The risks include reserve risk, issuer risk, de-pegging, regulatory risk and smart contract risk.

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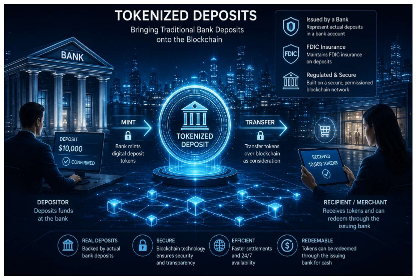

Tokenized Deposits

Tokenized Deposits

Tokenized deposits allow banks to represent traditional bank deposits as digital tokens on a blockchain or similar distributed ledger.

Stable Coin & Tokenized Deposit Distinctions

Stable coins are typically issued by a private company outside the traditional banking deposit system. Tokenized deposits are issued by a bank and represent an actual deposit in a bank account, typically maintaining FDIC insurance.

Tokenized Deposits as Transaction Consideration

Bank depositors may deposit funds at a bank, which the bank may then create (mint) an equivalent number of digital deposit tokens. Bank customers can transfer those tokens over a blockchain or distributed ledger as consideration for goods or services. The recipient can then redeem them through the issuing bank, converting them back to cash.

The underlying asset never stops being a bank deposit or maintaining FDIC insurance, assuming appropriate structure.

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Embedded Finance

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Embedded Finance

Core Participants

Embedded finance operates through sponsor banks, BaaS providers, and end-brands integrating financial services seamlessly.

Market Growth

The embedded finance market is rapidly growing, projected to reach $1.8 trillion by 2034 with over 30% annual growth.

Benefits for Banks

Banks benefit from reduced acquisition costs, expanded distribution, and access to new customer markets through embedded finance.

Risks and Compliance

Reliance on fintech partners poses regulatory risks; strong governance and compliance are essential for banks.

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Artificial Intelligence in Banking

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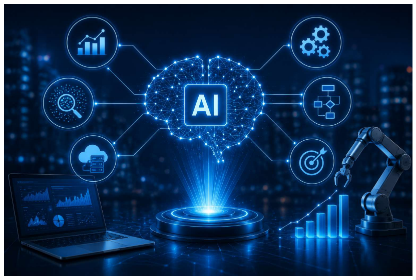

AI Simplified

AI Simplified

AI is essentially new and modern technological methods of gathering data and information that is used to produce a desired outcome using automated analysis rather than human effort.

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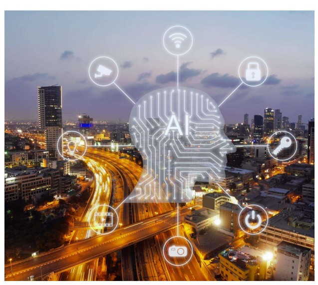

AI Adoption and Operational Impact

Operational Efficiency Gains

AI aims to streamline middle- and back-office processes, reducing manual workloads and improving efficiency ratios by up to 15%.

Enhanced Customer Experience

AI enables personalized customer engagement through real-time advice, chatbots, and automated onboarding cutting verification costs.

Wealth Management Support

Generative AI assists portfolio analysis, risk profiling, and tailored investment recommendations in wealth management.

Risk and Compliance Challenges

AI adoption introduces risks requiring strong governance frameworks to manage data quality, bias, and regulatory compliance.

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AI-Specific Applications

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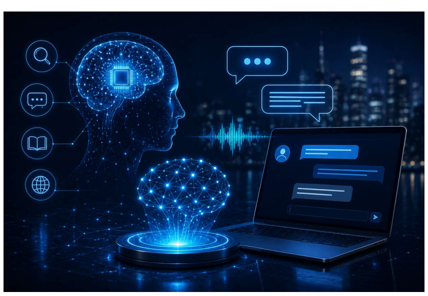

AI-Specific Applications

Expert Systems

Computer program that uses AI to simulate the judgement and behavior of a human or an organization that has expertise and experience in a particular field.

Natural Language Processing

Ability of a computer program to understand human language as it is spoken and written.

Enables computers to take real-world input, process it and make sense of it in a way a computer can understand.

Source: TechTarget.com

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AI-Specific Applications

Speech Recognition

Allows computers and applications to understand human speech data and, typically, converts to text.

Machine Vision

Computer's employment of video cameras, analog-to-digital conversion and digital signal processing to see, with resulting data typically going to a computer or robot controller.

Source: GNANI.AI & TechTarget.com

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Regulatory Overview

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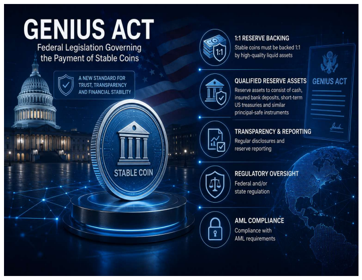

GENIUS Act

GENIUS Act

The GENIUS Act is a significant piece of federal legislation governing the payment of stable coins. The law generally requires:

- Stable coins to be backed 1:1 by high-quality liquid assets
- Reserve assets to consist of cash, insured bank deposits, short-term US treasuries and similar principal-safe instruments
- Regular disclosures and reserve reporting
- Federal and/or state regulation
- Compliance with AML requirements

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Clarity Act

Clarity Act

The proposed Clarity Act is designed to clarify regulation over the crypto ecosystem. It seeks to establish clear rules for digital asset platforms and oversight, including:

- Clarifying which digital assets fall under securities regulation versus commodities regulation
- Establishing clear rules for exchanges, brokers and market participants

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Risks to Community Banks

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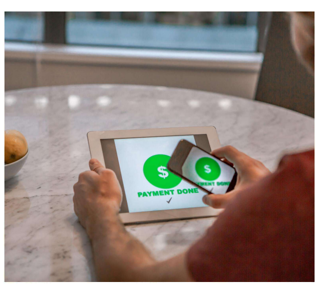

Disintermediation and Digital Competition

Rise of Decentralized Finance

DeFi enables direct lending, borrowing, and trading through blockchain without traditional intermediaries.

Peer-to-Peer Lending Platforms

P2P lending connects borrowers directly with lenders, offering faster approvals and flexible terms.

Reintermediation via Algorithms

Platforms use software algorithms for credit evaluation and fraud screening, evolving traditional roles.

Banks' Strategic Advantages

Banks retain strength in deposit insurance, regulatory compliance, fraud protection, and consumer trust to compete effectively.

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Deposit Migration and Interchange Decline

Impact of Stablecoins on Deposits

Stablecoins require separate reserves, causing customer funds to exit traditional bank deposits, limiting lending capabilities.

Declining Interchange Revenue

Debit interchange fees have steadily decreased due to regulatory caps and market pressures, compressing community bank revenues. Increased use of blockchain technology and alternative payment systems further promotes similar declines.

Strategic Challenges for Community Banks

Community banks face structural risks requiring strategic planning, regulatory engagement, and new revenue exploration.

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Action Steps for Banks

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What Are Community Banks To Do?

EDUCATE -

Community bank directors and executive officers should first seek to educate themselves on modern financial technologies, recognizing it is far beyond Bitcoin.

EXPLORE -

Opportunities to implement modern financial products and services through the bank, in both customer-facing and back-office channels.

EVOLVE -

Business practices to ensure ongoing stakeholder relevance.

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