

Fintech: Are banks responding appropriately?

Viewpoint



Ian Webster and Jeremy Pizzala suggest a different innovation approach to help banks get a better return on their fintech investment.

Digital disruption is at the top of the banking agenda across the Asia-Pacific region. But will the banks' response to the rise of fintech be effective? Merely jumping on the fintech bandwagon – or even building a successful fintech company – will not create a successful financial institution.

Banks don't just need to improve the customer experience, they also need to stay ahead of the innovation game. Incubators are good for customer and shareholder PR, but will they deliver actual innovation or just more apps? Banks are hiring world-class marketing consultants, but are incumbents backing up the messaging with real change in culture and product innovation? Do banks really want to take on the massive risks associated with fledgling startups? Do they have clarity around the development and price points that make a startup a commercially viable acquisition target?

Swept up in the fintech momentum, banks need a road map to look at why they're innovating and what requires innovation – while managing the new digital risks innovation introduces.

Fintech:

Are banks responding appropriately?

The rise of fintech

After decades of relatively low R&D spend, the early impact of fintech galvanized the banking sector into action. Having sat behind regulatory walls building large value chains, banks found their highly visible, commoditized products ripe for disruption. Bitcoin showed the potential for consumers to transact without a fee or a regulator. Peer-to-peer lending demonstrated a different type of disintermediation – and consumer appetite for it.

Right now, in the UK, accounting software giant, Sage, is partnering with two SME funding specialists to offer capital directly to its vast SME client base, bypassing the banks. Closer to home in China, WeChat's vast user base provides a ready-made market for Tencent Holdings' new bank joint venture, the purely online WeBank. If WeChat users can be converted into banking customers, mobile transactions and payments solutions are clear areas of opportunity. WeBank will also be able to take advantage of Tencent's extensive online experience and access to large amounts of customer behavior information to offer differentiated financial products.

But this is just the start. Globally, investment in these ventures tripled to US\$12.21b in 2014 – and the curve is continuing upward led by growing market confidence in the ability of digital startups to disrupt the banking market.

At the same time, Asia become the second most funded region for fintech, with investors equally excited by access to the world's largest unbanked population and a private wealth market about to overtake that of North America.

Poised for wide-scale disruption

Already, many of the pieces of the financial services value chain have been replicated by digital players. The second someone finds a way to "join the dots" and present customers with a holistic proposition, established banks will be in trouble. To this point, Germany's Fidor Bank is building FidorOS3, a middleware with an open Application Programming Interface (API) that can connect to existing core banking platforms to offer a range of modern services, including lending money to friends, sending money via Twitter and arranging an emergency 24-hour loan. Fidor's open API also allows third parties to access all areas of the bank system, unbundle relevant services and build new services based upon the bank's platform facilitating considerable innovation. This type of platform will soon allow customers to pull together best of breed solutions in a cohesive way.

The scene is set for an "Uber" scenario in financial services – one in which regulators could find a way to balance protecting the financial system with balancing innovation.

How are banks responding?

Banks have increased their total IT spend, first investing heavily in digital banking and currently pouring money into accelerators, alliances and innovation labs. Bank CEOs and COOs are increasingly referring to themselves as "IT providers."

Many major banks around the world now has either a startup program to incubate fintech companies, is putting aside venture capital to fund them or is partnering with, acquiring or launching their own fintech startup. Going one step further, Barclays is creating a global community for fintech innovation, including opening an accelerator in New York's Silicon Alley. Within Asia-Pacific, ANZ Bank has appointed "an international panel of technology experts" to advise its Board on the strategic application of new and emerging technologies and technological trends that could affect the bank's strategy.

As a result, across North America, Europe and Asia-Pacific, bank investment in IT is projected to grow US\$196.7b in 2015, an increase of 4.6% over 2014. This growth is expected to be particularly strong in Asia-Pacific, where it is predicted to rise by 5.6% in 2015 to US\$70.3b.

A different approach to innovation

Banks need a logical approach to achieving a clear point of differentiation with their fintech investment. Currently, much of the spend on incubators and accelerators appears to be either adding to the ever-expanding pool of fintechs or being channelled toward funding similar projects – many of them focused on developing apps. This is not an approach likely to fend off the very real threat of wide-scale digital disruption.

Instead, banks need to take a step back and interrogate their innovation strategy from the ground up, asking:

'Why' are we innovating?

What's really driving the innovation agenda? Is it being demanded by customers or shareholders – or is it integral to strategy? Is it defensive, responding to ward off potential threats – or offensive, taking advantage of clear market or customer acquisition opportunities?



'What' are we innovating?

Banks must decide if they are:

- ▶ **Building out from their traditional strengths** – innovating in the areas of financial services that startups find hard to emulate, such as credit decisioning or regulatory compliance. This can be highly effective, with opportunities to add value by offering advice, improving access, connecting customers or protecting personal/financial interests.
- ▶ **Developing market-facing innovations** – inventing new propositions or functionalities either to offer customers branded innovations or to pursue white-label opportunities. For example, in South Korea, Woori Bank, the flagship unit of state-run financial group Woori Financial Group is planning to partner with mobile carrier KT to use its location-based system to track movable assets such as vehicles and machinery. The lender plans to encourage borrowers to use movable assets as collateral.
- ▶ **Innovating at the enterprise level** – harnessing middle and back office innovation, or workforce engagement to impact the front office. For example, Singapore bank DBS is promoting a "digital mindset" among employees, through a series of hackathons that pair in-house staff with local entrepreneurs to jointly tackle business problems. At a recent DBS Bank "MegaHackathon," the bank embedded 150 DBS employees with local startups to work on a range of mobile banking prototypes.

'How' should we be innovating?

Banks need to decide on the right innovation model. Should they build, borrow, fund or buy? Fintech is not a "one and done" problem – it requires innovation "little and often" and on a far shorter development cycle than the traditional model. It also requires an "agile" (iterative, efficient and responsive to real-world issues) rather than a "waterfall" approach. Many banks have realized they lack many of the capabilities needed to deliver this and are not confident they can develop or acquire a dedicated innovation team in a reasonable timeframe. Under these circumstances, outsourcing is an attractive option.

This is why funds, incubators and accelerators are everywhere, and are increasingly being constructed as collaborations, reflecting the open innovation that is at the heart of the digital revolution. A plethora of hubs in Australia, funded by venture capitalists and

the banks themselves, and linked to a vibrant fintech startup community, provide a focus and impetus for fintech innovation. Tyro, Australia's only independent EFTPOS (electronic funds transfer at point of sale) provider, has created a hub for Sydney's fintech entrepreneurs to co-work, co-develop and co-market. Each quarter, Tyro selects one company to dedicate resources, banking access, and expertise to co-develop open APIs, offering investors the opportunity to buy equity at different stage-gates.

While investing in such collaborations is becoming the norm for financial services incumbents, the challenge is how to embed the new technology and agility given the stark cultural differences between a global bank and a startup. Large banks have traditionally gained economies of scale and economic advantage through "industrialization" of their products and processes (see *EY Journal of Financial Perspectives*, March 2015, Volume 3, Issue 1) and have prioritized partnering with others in their own industry – especially where there is an opportunity to share processes or services that are considered non-core and which help all collaborators either reduce their costs or create a new market opportunity. The future challenge for established players will be to collaborate more closely with those in different industries and with different outlooks and maintain cost efficiencies. Different operating models will emerge.

Beyond these challenges is the bigger question of whether this risky, early-stage funding is really a bank's best option? Would banks be better to wait until innovations reach the proof of concept stage? At this stage, the purchase price would be higher, but the risk of failure would be lower.

Banks also need to decide where and how to hedge their bets by investing in competitive innovation to their own core services, such as Westpac's VC fund investing A\$5m in Australia's first active peer-to-peer lending platform, SocietyOne.

Digital assets need a digital risk platform

However banks choose to innovate, as they build out their fintech strategy, they also need to build in a layer of cyber security, given the burgeoning wave of cyber attacks exploiting the digitization of business across all industry segments and especially in financial services. Fintech developments, such as quantum computing, mean that focus in this cyber risk will need to further intensify as we see increasing emphasis on quantum encryption to secure payment transactions. An Australian Big 4 bank is already sponsoring research into quantum computing with a US\$5m contribution to an Australian university leading this research.

Conclusion

Success in the digital era depends on a bank's ability to respond logically to the threats and opportunities of fintech innovation. Executives must ask themselves why, what and how they are innovating – and have great confidence that each answer is grounded in a robust growth strategy and protected by a digital risk platform.

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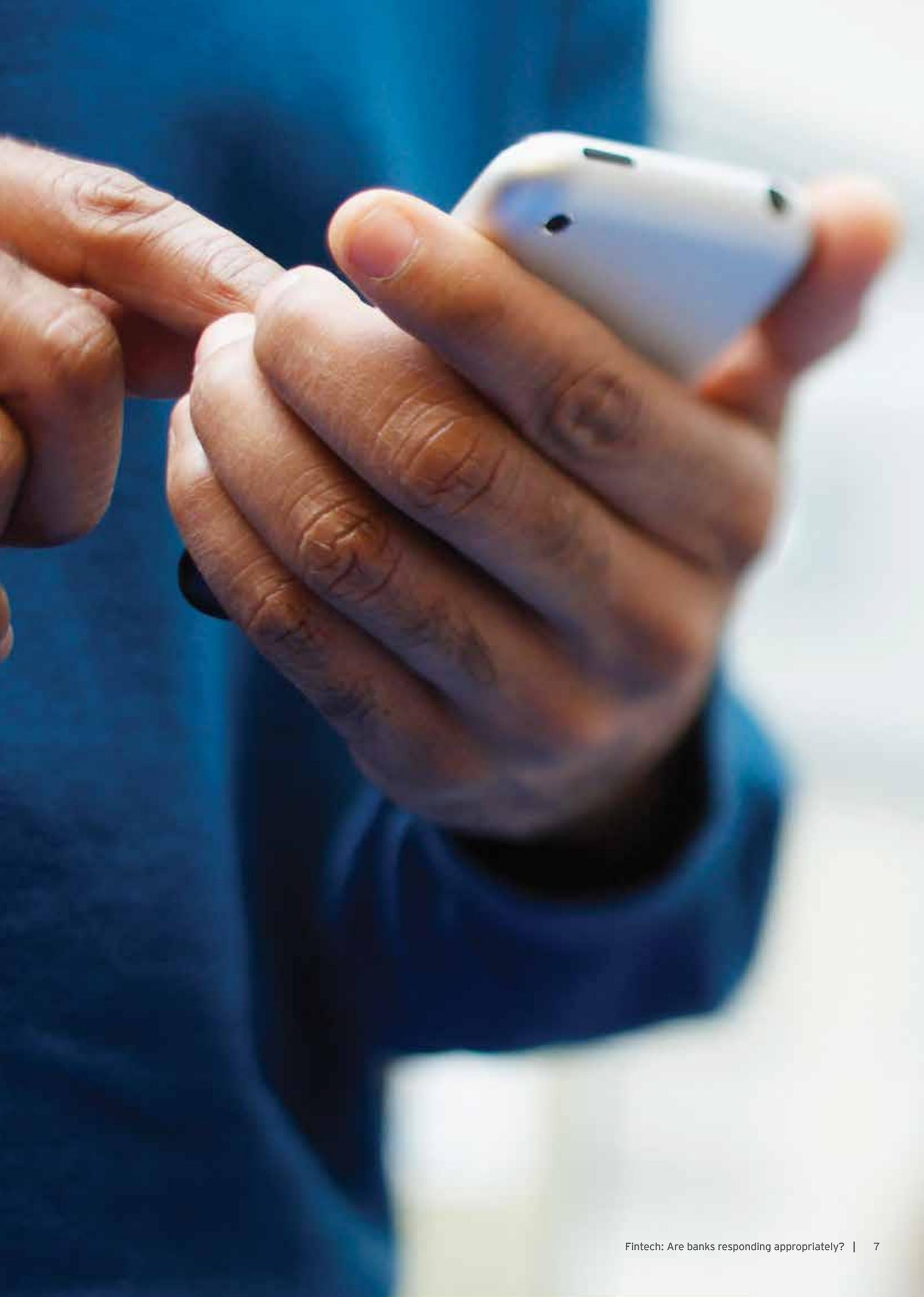
Embedding risk in digital innovation

When planning how to protect their fintech initiatives, banks need to consider:

- ▶ Embedding security as part of the initial design phase, by identifying business use cases, developing threat models and associated controls
- ▶ Developing identity and access management in their cloud ecosystem
- ▶ Implementing framework controls that incorporate the end point device, like a tablet or PC because, even if the device is authenticated, attackers can still gain ingress
- ▶ Ensuring source and target systems are not a source of systemic risk, especially vulnerable legacy applications
- ▶ Adopting adaptive access, which enforces authentication requirements for higher risk and higher value transactions before the transaction request can be approved, thereby maintaining a good balance between useability and security
- ▶ Embedding “privacy by design” into their fintech strategies – with a well-constructed privacy program that recognizes the need to comply with regulation while also preventing privacy from blocking digital innovation
- ▶ As cyber attacks become increasingly sophisticated, fraud and transaction monitoring should be implemented, based on anomalous behavior detection, to identify fraudulent or malicious patterns and apply appropriate controls
- ▶ Educating customers, employees and third parties on the common tools and techniques used by malicious actors to use them as a point of entry into the organization, especially phishing and social engineering
- ▶ Creating a digital ecosystem risk management framework, including:
 - ▶ Identifying all flows of data to and from third parties and all system and application access points in the ecosystem
 - ▶ Regular due diligence reviews of third-party cyber security controls
 - ▶ Embedding contractual obligations that define security requirements
- ▶ Validating that security investments have improved their security posture

Because fintech is inherently digital, the banking sector's wide scale investment in this area requires an increased focus on cyber security. By building their digital assets on the top of a holistic digital risk platform, banks will help to protect their brand, intellectual property, customer data and help to ensure availability and a strong customer experience.

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