The Banker

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SPECIAL REPORT

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BANKING ON PURPOSE
Adding value

After a tsunami of scandals comes the reckoning. But are financial institutions ready to do some soul-searching and rethink how they add value to society? Joy Macknight investigates.

BANKS ARE FACING AN EXISTENTIAL CRISIS ON TWO FRONTS. First, they are still grappling with the fall from grace in the eyes of the general public as a result of the global financial crisis. The ensuing bank scandals, including the misselling of products and price rigging, only strengthened the feeling that banks are not working in the public's best interest but are doggedly focused on maximising profits and shareholder return instead.

Second, traditional banks are contending with a wave of nimbler financial technology (fintech) start-ups coming in between the banks and their customers, offering a slicker experience and changing expectations of what financial services should look like.

A FRIGHTENING FUTURE

According to EY's Global Consumer Banking Survey 2016, which polled 55,000 customers across 32 markets, one in three consumers believes that there will not be a need for traditional banks at all in the future. Four out of 10 customers express both decreased dependence on their bank and increased excitement about what alternative companies can provide. And while less than half (42%) of consumers have used non-bank providers in the past 12 months, 21% of the remaining are considering doing so.

"Banks are being forced to think harder about their reason for being," says Peter Sands, ex-CEO of Standard Chartered Bank and current senior fellow of Harvard Kennedy School at Harvard University. "The public is asking high-level questions about the value that banks add to society and the trade-off between private gain and public risk. In addition, there is a more technology-driven micro-ask of the banks as to what their purpose is.

"The combination of those two things is a fundamental challenge to the banks, both in terms of the right to play within society but also in the ability to have a sustainable business model," he adds.

Anthony Jenkins, ex-group CEO of Barclays and currently executive chair of cloud platform 10x Future Technologies, says: "The financial crisis of 2008 revealed how many banks were too aggressive, too self-serving and too focused on the short term, and I am convinced that only companies that consider the long-term impact of their actions on society will be able to build a sustainable business. In other words: there can be no choice between doing well financially and behaving responsibly in business."

> PURPOSE IS ABOUT WHY THE BANK IS HERE AND ITS ESSENCE FOR PERHAPS THE NEXT 30 TO 50 YEARS
> *Hugh Harper*

"The banking industry needs to return to doing what it is supposed to be doing – serving real people, businesses and the economy – and win back the trust of society one customer at a time," says Andy Maguire, group chief operating officer at HSBC.

REBUILDING TRUST

Today, many banks are reframing their purpose to reflect the new and emerging demands of society and industry. Phil Harkness, global leader for purpose-led transformation at EY, defines purpose as "an aspirational reason for being that is grounded in humanity and inspires a call to action".

He believes that it makes good business sense to be purposeful. "A purposeful organisation's employees are more engaged, more satisfied and more likely to remain committed to the company. The same applies to customers – many would drive across town to support an organisation whose purpose is worthy, understandable and supportable," he says.

Kris Pederson, EY's Americas advisory strategy and customer leader, adds that being purposeful is of particular interest for the millennial generation. "If a company isn't purposeful, millennials and Generation Z are more likely [than previous generations] to either move to one that is or start their own businesses," she says.

While many banks have a purpose statement, some are more purposeful than others. For example, Bank of America's purpose is in "helping to improve financial lives through the power of every connection"; Wells Fargo's vision is "to satisfy our customers' financial needs and help them succeed financially"; and Morgan Stanley says it believes "capital can work to benefit all of society".

These encapsulate the broader mandate of contributing to social wellbeing, whereas Goldman Sachs' aim to "provide superior

return for our shareholders" perhaps reflects old-school thinking.

ACTION AS WELL AS WORDS

But even a well-defined purpose does not guarantee exemplary behaviour, as evidenced by Wells Fargo's recent accounts scandal. Organisations must "activate" their purpose, argues Michael Giarrusso, partner, financial services advisory, at EY, in order to ensure that the culture of the organisation reflects its purpose. "Banks need to demonstrate that they are living these values, not just paying lip service to them," he adds.

In order to deliver on purpose, it needs to be activated in all aspects of the business, including recruitment, products and services, technology, performance evaluation systems, customers, suppliers and investments. "Every action a bank takes should be seen through the lens of whether it is furthering its purpose or not," says Mr Giarrusso.

It is important to understand the difference between purpose and strategy, according to Hugh Harper, strategy and operations leader for Europe, the Middle East, India and Africa financial services at EY. "Whereas corporate strategy looks three to five years in the future, purpose is about why the bank is here and its essence for perhaps the next 30 to 50 years," he says.

As many of the people at the top of an organisation will not be responsible for the delivery of purpose because of their short tenure, it is critical the development of purpose engages and is supported by customers, employees, institutional stakeholders and others who have a long-term interest in the organisation's sustainable success, says Mr Harper.

PURPOSE IN ACTION

Mr Jenkins agrees that banks must put purpose and values at the heart of all they do if they are to drive high performance for their customers, colleagues, shareholders and society.

"This involves clearly defining purpose and values; changing the systems of the organisation such as promotion and compensation to support the purpose and values; ensuring purpose and values are operative in decision making; using data to measure progress; and, crucially, leaders modelling the behaviours required," he says.

Both Ms Pederson and Mr Giarrusso commend credit unions, such as Coast Capital Savings and Vancity for their ability to deliver on purpose. "Focus and passion on their purpose permeates everything they do," says Ms Pederson. "They live value, with a different way of operating, and that can be seen through the whole lifecycle of customer engagement."

"Coast Capital is a 'for-purpose' organisation," says Don Coulter, CEO of Canada's largest credit union based on membership. "We exist beyond simply wanting to earn profits and believe we can generate benefits for many stakeholders." Coast Capital Savings' purpose is threefold: improve its members' financial well-being; excel as an employer of choice; and invest in communities.

"We engage genuinely, authentically and in accordance with our purpose," says Mr Coulter. "It is a virtuous cycle: the more successful we are at helping our members, the more members we attract, the more resources we have to invest in employees and innovation, and the stronger our communities become."

In addition to promoting financial literacy and wellbeing programmes, Coast Capital sponsored Booster Buddy, a free app designed to help young people with mental health issues. Today, more than 100,000 people have downloaded the app, which provides online counselling tips in a user-friendly, game-type application. The credit union also has joint ventures with local universities to support start-ups through the incubation phase to become viable businesses.

INNOVATIVE SOLUTIONS

Vancity, whose purpose is to "redefine wealth in a way that furthers the financial, social and environmental well-being of our members and their communities", also goes beyond strictly financial services to support its membership. In May 2015 it partnered with Immigration Services Society of BC, a non-profit organisation, to help refugees' settle in British Columbia.

Tamara Vrooman, CEO of Vancity, says: "The majority of Vancity's business used to be based in traditional financial services, but in 2012 we began shifting to a business model of member-led innovation. We develop innovative solutions working with partners to meet members' needs and grow a more resilient economy. All of these are essential to how we activate our own vision."

The credit union is a member of the Global Alliance for Banking on Values, an independent network of financial institutions that focuses on a triple-bottom-line approach: people, the planet and profit. Other members include Bank of Palestine, Europe's Triodos Bank and XacBank in Mongolia.

"It's important to acknowledge that financial institutions do not have a neutral or benign role in society. They have both the power and responsibility to allocate resources in ways that not only do no harm but also create positive outcomes," says Ms Vrooman. TB

IF A COMPANY ISN'T PURPOSEFUL, MILLENNIALS AND GENERATION Z ARE MORE LIKELY [THAN PREVIOUS GENERATIONS] TO EITHER MOVE TO ONE THAT IS OR START THEIR OWN BUSINESSES *Kris Pederson*

GETTING THE MOST OUT OF DIGITAL TRANSFORMATION

Innovation

Banks are investing vast sums into digital programmes but are not yet reaping the benefits. Joy Macknight examines where banks are focusing on in order to create – and capture – value in digital.

THE ECONOMIC EQUATION IS NOT YET PROVEN BUT IT WILL BE IN THE FUTURE, AS LONG AS BANKS LOOK AT THE ENTIRE DIGITAL CHAIN, AND NOT JUST THE FRONT-END INVESTMENT

Yannick Grécourt

THE VALUE OF DIGITAL BANKING IS WELL UNDERSTOOD FROM THE CUSTOMER'S PERSPECTIVE, and can be measured in convenience, choice and price. With digitisation, financial services are on tap 24/7 and can be accessed through multiple channels; customers expect enhanced and more personalised products and services.

However, capturing the value of convenience and choice is proving difficult for banks, particularly with new competitors entering the market. While most financial technology (fintech) start-ups typically focus on a narrow offering, they can offer services for a fraction of the price as they do not have to deal with the same legacy or regulatory issues incumbent banks face. Across many different business lines, fintechs are effectively unbundling the financial services value chain.

This has created a profit conundrum for banks, particularly when they are ploughing millions of dollars into digital transformation projects at the same time. "There is a risk that most of the value will be passed to consumers in the form of better service and greater convenience but may not translate into additional value and profit for banks," says David Dab, head of innovation at ING Belgium.

A BETTER EXPERIENCE

David Ebstein, head of digital for Europe, the Middle East, India and Africa financial services at EY, believes that in the future banks will be able to capture value from improving the customer experience. "Digital provides a greater choice of channels and flexibility in relation to where and when customers can interact with their bank. It can also reduce costs for the bank because it automates operations and moves clients to self-service channels, as well as manage risks more effectively," he explains.

However, to date the cost-to-income ratio has not shifted in the banks' favour. "For now it continues to drive up cost for two reasons," says Yannick Grécourt, partner of strategy, customer and operations at EY. "First, many banks are rolling out developments on existing legacy systems where the processes are not fully automated or digitised. Second, there are still a significant number of people who view digital as just one of many banking channels."

Despite these challenges, Mr Grécourt believes there is no alternative to going digital. "The economic equation is not yet proven but it will be in the future, as long as banks look at the entire digital chain, and not just the front-end investment to improve the customer experience that has happened so far," he says.

DEEP RENOVATION

Instead of converting existing processes and products to digital, banks should rethink their entire offering, as well as the product delivery system, according to Mr Dab. "Through digitisation it is possible to produce and distribute in an entirely new way," he says.

Marc Raisière, chief executive of Belfius, a Brussels-based bancassurance firm, advances new ways of engagement. "[Banks] need to engage in a real digital transformation and change their vision with regard to sourcing, fintech and digital players. The debate is not so much 'banks versus fintech', but how to collaborate, build partnerships and create win-wins," he says.

Mr Dab agrees, saying: "The world is opening up through APIs [application programming interfaces], which allows banks to mix together resources and assets from different places and combine them in an open environment."

Head of client and customer experience at Barclays, Matt Hammerstein, zeroes in on the UK Competition and Markets Authority's "open banking revolution" in the UK, as well as the second iteration of Europe's Payment Services Directive and the recent European Data Protection Regulation. "My expectation is that those three taken together will fundamentally transform the way customers think about what they want from a bank and ultimately the way banks have to think about how to go to market to serve them," he says.

A NEW WAY OF WORKING

Felimy Greene, regional head of customer franchise at Citibank's Asia-Pacific and Europe, Middle East and Africa business, also emphasises the capacity of APIs to usher in a new way of working for banks. In November, Citi published a set of APIs that opens up 80% of its banking functionality to third-party developers. In less than a week, Citi had more than 1000 developers from around the world registering to gain access to functioning APIs in a sandbox environment, with artificial data to build working prototypes, Mr Greene reports.

Within a week, several start-ups had built working applications integrated with Citi APIs and exhibited on the bank's stand at the Singapore Fintech Festival. "The imagination and creativity that we can harness by opening our doors to the outside is extraordinary," says Mr Greene. "We believe that banks can't build, own and operate everything by themselves anymore – the world is clearly no longer working that way. We want to partner, collaborate and play a scale-enabling role in the fintech revolution."

Likewise, HSBC is investing in making it easier to work together with third parties, moving beyond a world where banks build everything in house. The bank is also moving away from multi-year IT change programmes, according to Josh Bottomley, chief digital officer at HSBC, and is looking to release deliverables based on minimum viable products and regular iterations. "That means we can deliver benefits faster for our customers and fine-tune our investment priorities and delivery roadmaps," he says.

THE RIGHT SKILLS

Mr Bottomley touches on one of the biggest challenges banks face when going digital: pivoting the whole organisation to an agile way of working. As Mr Dab says: "An incumbent bank hasn't been designed for innovation. And to make it more innovative is a big transformational challenge, with changes to processes, culture, mindsets, behaviour, incentives, performance management, organisation skills and so on."

Mr Dab believes that opening up the bank to the outside world will solve a big part of the culture challenge. ING, for example, launched its innovation bootcamp in 2014, and the bank benefits from developing great ideas, but also experimenting with new ways of working in a risk-free manner. ING Belgium also launched a fintech village, where it hosts selected external fintechs for three or four months. "We believe that much of our innovation in the future will come from outside," he says. "Therefore we work, collaborate and partner with fellow providers, start-ups, fintechs, and so on."

And by changing the culture and modernising the way they work, banks may just have a chance at attracting top talent to fuel further transformation. "Many banks tour Silicon Valley looking for inspiration for their management teams. But banks must also promote a culture of innovation throughout their firms to retain the best and brightest," says Anthony Jenkins, ex-group CEO of Barclays and current executive chair of 10x Future Technologies, a cloud computing firm.

"That doesn't just mean hiring people who can come up with new ways to trade financial derivatives; it means encouraging all employees to find ways to contribute to the business as a whole, whether it's internal processes or new products," he adds.

"As part of Citi's pivot to an agile way of working and being more customer-centric, we are hiring people from a wide range of non-financial backgrounds and putting design at the centre of what we do," reports Mr Greene. It has integrated in-house design teams into all the bank's customer experience activities. The bank has also incorporated legal and compliance experts into project 'scrum teams' to flag and resolve any potential regulatory issues at the earliest opportunity.

VALUE IN THE COMMUNITY

In the future, Mr Ebstein envisages a new style of banking that goes beyond the current situation. "Banks are well placed to play a bigger role in their customers' lives than just providing a mortgage or a credit card," he says. "They should be looking at providing broader services that help their clients to manage multiple aspects of their lives. And while the banks themselves may not provide all the products and services, they could develop and manage a trusted partner ecosystem."

"With many banks trimming their workforce, one could imagine a bank starting large-scale education programmes to retrain people and address the industry's skill shortage, something like a university," he suggests. "Moreover, instead of closing branches, banks could use them to help local communities, for instance by supporting new entrepreneurs."

Barclays is doing the latter. It has launched nine Eagle Labs in the UK, converting branches into spaces to help small businesses and those in the local community who have technology-based capabilities to do rapid prototyping and come to market. "We help new businesses engage with the local community, which in turn will help them to become unicorns of the future," says Mr Hammerstein. TB

> THERE IS A RISK THAT MOST OF THE VALUE WILL BE PASSED TO CONSUMERS IN THE FORM OF BETTER SERVICE AND GREATER CONVENIENCE BUT MAY NOT TRANSLATE INTO ADDITIONAL VALUE AND PROFIT FOR BANKS
>
> *David Dab*

HOW TO SURVIVE IN THE NEW REGULATORY AGE

Regulation

The banking industry is facing massive disruption, not just from the new entrants in the market but also from regulatory pressures across many jurisdictions, writes Justin Pugsley.

A DECADE FROM NOW, BANKING WILL BE VERY DIFFERENT FROM WHAT IT IS TODAY, as it is reshaped by technological innovation and growing regulatory demands.

New players will emerge – some from outside traditional banking – and new business models will take hold. Banking is currently caught in a pincer movement between rising regulatory costs and challenging market conditions against a background of rapid technological progress, which is both a threat and an opportunity.

REGULATORY PRESSURE

Huge regulatory pressures emanating from G20 initiatives following the financial crisis and more recently anti-money laundering (AML) and anti-terror legislation have forced banks to lean more heavily on technology to counter dwindling returns on capital.

"Capital levels have gone up dramatically," says John Liver, global regulatory reform leader for Europe, the Middle East, India and Africa (EMEIA) financial services at EY. "Compliance teams have increased considerably, with much of the recent hiring around financial crime, transaction monitoring, testing and AML. It all adds up to big numbers."

For instance, Federal Financial Analytics, a policy analysis firm, estimated that the six largest US banks spent a staggering $70.2bn in the six years to 2013 on regulatory compliance. One of those banks spent $50m in 2015 on technology and talent just to deal with US resolution rules.

The main regulation-related costs are for building the systems, establishing processes and higher capital requirements. Though the regulatory reform agenda is nearing completion, particularly on the prudential side, banks still face years of investment while also digesting a fast-growing volume of conduct rules.

DEMANDING CUSTOMERS

Their spend needs to cover not only compliance, but also changing customer requirements around digitisation and convenience, in order to help fend off competitors.

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> ***John Liver***

"At Barclays we've been rolling out a programme over the past three to four years, where we've spent more than £150m [$189m] transforming our compliance function," says Mike Roemer, group head of compliance at Barclays Bank. That investment has been split between two areas: technology and in defining the role of compliance officers by training them in new ways of operating.

Barclays' technology spend has been heavily dedicated to e-commerce surveillance, combating crime, compliance and electronic communication capabilities, and could end up absorbing another £100m over 2016 and 2017 to keep pace with rapid technological change.

Know your customer (KYC) and AML, always important for banks, are receiving more attention as regulators continue to tighten rules. "It's one of the most expensive areas for compliance. It's very competitive as there's a lot of poaching of talent, as well as a need to keep pace with technology because of cyber risks and data privacy issues," says Mr Roemer.

Though technology is crucial for business sustainability – some banks still use traditional approaches to maintaining profitability – "some are attacking [higher capital requirements and charges] through complex treasury management systems that aim to optimise collateral", says Neil DeSena, the managing partner of SenaHill, a merchant bank bringing together global banks and financial technology (fintech) innovators.

"Others approach it from a non-traditional way, such as creating new instruments to offload credit risk, which will virtually eliminate billions of dollars in capital requirements and charges," he adds.

DATA IMPORTANCE

A silver lining in this regulatory raincloud is the accompanying demand for data needed for regulatory compliance. True, it is proving enormously expensive to put all the new systems in place to collect and process all this data, but it is also forcing banks to become more efficient and data-centric. One exciting development is the creation of 'data lakes', where the various banking functions, such as marketing, can pick up on new trends and compliance can detect unusual activity requiring investigation.

One important area where data will play a role is in restoring trust between banks and users. So called de-risking is making banks nervous of dealing with some of their peers or taking on certain clients in case AML issues surface, which could lead to harsh regulatory sanctions. The emergence of e-passports should in future make checking

identities far easier and more robust, and will help restore 'trust' among participants.

However, most big banks have been built out of merger and acquisition sprees and remain an amalgam of different processes, cultures and IT systems. The current cost pressures are a catalyst to finally integrate these various bits of the organisation.

"You need to get all these systems to talk to each other before you can get the efficiencies and economies of scale," says Fran Reed, an ex-investment banker and regulatory strategist with financial research solutions provider FactSet. He adds that though this process is challenging, it can drive big rewards.

Meanwhile, investors are becoming impatient as they watch banks deploy vast amounts of capital to remain in business while their returns on equity have languished for years. "The cost pressures are such now that boards and investors have been asking to see the value in all the investment that's gone into new systems and they want to see the difference it has made before they go through another round of investment," says Mr Liver.

COLLABORATE TO SAVE

One route to lower costs is collaboration. A recent example is Project Sentinel, a multi-bank initiative to share implementation costs on the pieces of the EU's Markets in Financial Instruments Directive II (MiFID II) requirements for dealing in over-the-counter securities.

Sentinel aims to automate, generate economies of scale, create consistent interpretations of MiFID II and build in flexibility so it can work with other regulatory regimes such as Dodd-Frank in the US. But third-party providers are also bringing financial institutions together in new ways to offset concerns over falling secondary market liquidity in fixed income, for example.

Toronto-based Overbond, a platform that brings together bond market participants, is one of those initiatives. Chief executive Vuk Magdelinic explains that broker-dealers, many of which are bank owned, often only have a limited number of relationships, which is a problem with falling liquidity levels.

"The platform offers them the ability to form relationships with more market participants," says Mr Magdelinic. He adds that it leads to better pricing and for new issuance allows originators and sponsors to get a better feel for where new issuance might be priced.

TECH USE

Banks are also capitalising on technology to enhance their competitiveness. BNP Paribas, for example, over the next three to four years is looking at how to deliver better customer experience and is adapting its client relationship models using new technologies relating to the web and virtual agents. "We're still in the early stages and are working on several prototypes," says Philippe Ruault, chief innovation and digital officer at BNP Paribas.

He says the bank is looking at increasing automation to improve reporting to clients and regulators, and investing in new technologies – including digital signatures and optical recognition – to support the customer experience and protect against cyber crime.

Areas such as automation hold real promise for delivering cost savings and improving data quality. "The whole field of robotic process automation is effectively looking at the work done by humans that a robot can take over, such as data collection, aggregation and reporting – that has been a huge area of focus for efficiency gains where vendors promise savings of 30% to 50%," says Patrick Craig, regulatory technology leader for EMEIA financial services at EY.

Banks are particularly keen on using automation for tasks relating to KYC, due diligence, transaction monitoring, investigations and sanctions. These areas can involve a lot of manual labour and create risks from human error. For instance, when analysing the work of due diligence and investigative teams, it is not uncommon to find that up to 80% of their time can be dedicated to data collection and aggregation, while just 20% is spent making a judgement call or passing it further up the chain of command for a final decision.

FUTURE OF BANKING

Mr Ruault believes that in the future banking will move towards platforms that might host products from other providers but would ultimately leverage a large bank's diverse client base, capital position, trust and brand name. This could be a basis for developing new business models involving third parties or enabling clients to more easily do business with each other.

"Play forward the fourth industrial revolution around data and analytics – this shifts how you begin to imagine future banking services," says Mr Craig, who also sees a future where customers coalesce around trusted platforms or ecosystems to obtain the financial services they want. "Think of it as being a bit like apps on a smartphone," he adds.

Mr Craig also foresees greater specialisation taking place in financial services, particularly around high-risk areas that require advanced risk management skills. TB

THE WHOLE FIELD OF ROBOTIC PROCESS AUTOMATION IS EFFECTIVELY LOOKING AT THE WORK DONE BY HUMANS THAT A ROBOT CAN TAKE OVER, SUCH AS DATA COLLECTION, AGGREGATION AND REPORTING

Patrick Craig

THE VALUE IN FINTECH *Technology*

To offer real value to investors, clients and partners, fintech companies need to balance opportunity, solution maturity and a sustainable business model, writes Dan Barnes.

For incumbent banks and investors looking to partner with – or make a return from – the many financial technology (fintech) start-ups in the market, it is easy to get swept away with the hype. A lot of the ideas being discussed are completely new and innovative, and for many long-standing businesses the process of digitisation is compelling new ways of working.

Fintechs are a key part of the new landscape and are seen both as rivals and partners to existing financial service providers, with some offering a completely new service altogether. Their technological element should add value to the service and in some way disrupt the existing business model. As Philippe Gelis, chief executive at foreign exchange and payment fintech specialist Kantox, explains: "Without an element of disruption, we are talking about financial services with a technology component, not fintech."

At a high level, disruptive innovation can have two main impacts within finance, says Matt Hatch, Americas fintech leader at EY. "The first is providing financial services to the unbanked or under-banked," he says. "There are 2.5 billion people globally who don't have access to financial services, either in its entirety or partially, but 1 billion of those now have smartphones, which can act as a gateway [for financial services]. The second impact is felt through the provision of cheaper, more accessible and more value-added services for those who already have access to financial product and services."

There are 2.5 billion people globally who don't have access to financial services, either in its entirety or partially, but 1 billion of those now have smartphones, which can act as a gateway [for financial services]

Matt Hatch

IDENTIFYING THE OPPORTUNITY

Digging a little deeper, the 'financial' part of 'fintech' may span many different businesses, across the capital markets, retail banking, wealth management and insurance. Fintechs are looking to provide specific componentised services in these spaces, or even a full service such as retail banking. Whatever idea the firm may have at its core, the disruptive element has to be embedded within its intellectual property if it is to be viable in the long run.

"Is a company just using the internet to create an agency model, or is it actually building sustainable advantage via analytics?" asks Giles Andrews, CEO of direct lending platform Zopa, a fintech that launched in 2005.

Mr Gelis adds: "I think it will become harder for fintech firms that are market-driven and are basically disruptive by just being cheaper; the long-term value resides in a firm that has technology that adds value both for the user and the industry."

The competitiveness of the field, the size of the opportunity and customer demand are different in each sector and affect the capacity to disrupt. To illustrate, 17.6% had used fintech services for payments, 16.7% for investment and saving, and just 7.7% for insurance, according to EY's Fintech Adoption Index, which surveyed 10,000 digitally active people globally.

Imran Gulamhuseinwala, global fintech leader at EY, says: "Trying to engage with and enthuse a customer through traditional financial services products is tricky. For example, I have yet to see anyone dropping into a bank branch because they get a kick out of refinancing their mortgage."

DISRUPTIVE REGULATION

Regulation presents an opportunity to plough a new furrow in an existing business, either to help overcome a compliance challenge or to fill a new service role. Retail banking is being actively disrupted by regulators who, via the EU's Payment Services Directive 2 (PSD2) and the UK's Open Banking initiative, are forcing the incumbent firms to open their application programming interfaces to third parties. Fintechs will be able to gain permissioned access to client account and transactional data, and can then offer services directly to bank customers, including services that compete directly with the banks, such as payments.

"PSD2 is a game changer for me," says Mr Gelis. "Banks will have to share all of their customer data, creating a viable basis on which firms can offer new services that have not existed before. Payment providers may be given permission to initiate transactions on behalf of banks' clients. This means that banks are losing the client relationship, which is where the money is."

In addition to the UK and EU, China is also seeing a revolution in the payments space. In the second quarter of 2016, the

People's Bank of China reported that a greater volume of electronic payments in China were transmitted by non-banks than by incumbents, according to James Lloyd, Asia-Pacific fintech leader at EY.

"[In China] banks continue to dominate in terms of high-value payments, but non-banks are disintermediating person-to-person and retail payments," he says.

STRUCTURING AND TIMING

Having spotted an opportunity and a viable solution, the right team and structure will be essential for a fintech to grow its business and be successful. In addition, tapping industry experience can be useful when establishing a business model. While early entrants were able to capture first-mover advantage, many of these entrepreneurs – and their backers – lacked finance services-specific expertise, says Mr Gulamhuseinwala, leading to problems in modelling the cost of customer acquisition.

"They frequently modelled [customer acquisition] at about $15 to $20. It's fair to say that they were in for a shock when they found these costs often to be 10 times that amount," he says. "Many fintechs still haven't worked out how to cost-effectively connect with the public. They are now reaching out to the financial institutions that have those relationships and hence end up working with banks."

However, while a larger partner on board can be highly advantageous in getting access to an existing customer base, those sorts of relationships are only viable once the start-up has proven its idea can stand up, according to Mr Andrews.

"You can't launch a fintech business solely based on a partnership, as you haven't proven your capabilities," he says. "When fintech businesses launch, often they define themselves by what they aren't – mainly because the market understands the alternative. For example, Zopa wasn't a bank. As a fintech develops proven capabilities, then it can start to define itself by what it is and begin to look for partnership opportunities."

PATIENT APPROACH

Having patience when maturing the start-up has other advantages. Entering a field where mistakes have already been made, and can be learned from, will allow the start-up to keep its feet when early in the process of building the business and establishing its sustainability. It can also help if one is not trying to engage with a concept for the first time, notes Mr Andrews.

"In some cases it's helpful not to be the first because one of the things that most businesses like ours are trying to do is change people's fundamental behaviour and that's hard, involves building quite a lot of trust and takes time," he says.

SUSTAINABILITY AND DISRUPTION

Once a fintech has tapped a rich vein with a robust disruptive solution, it will still need to ensure it can sustain momentum. That will require a support network of partners, investors and advisors to help it grow. Those firms wishing to work with fintechs will need to exhibit an understanding of the model that allows these innovators to grow, and not force them into an existing corporate model.

That also means supporting start-ups when they can deliver better value for the customer, instead of pushing customers toward traditional models outside their chosen platform. "If you look at the massive success of the Chinese fintechs, you'll see that it's not a good idea to have your customers go 'off ramp' and then come back on again," says Mr Gulamhuseinwala. "It is much better to embed the transaction within your offering from the outset and retain control of the relationship."

China has provided some innovative examples of fintech models, in part because the banks remained almost exclusively focused on servicing state-owned enterprises and corporates, while the majority of consumers and small businesses were unable to access basic credit and investment products. EY's Mr Lloyd says: "There was a vacuum into which some of these technology players moved with solutions that were an order of magnitude better than those that previously existed."

Some of these models, such as the collaboration between digital retail giant Alibaba and Tianhong Asset Management, whose products are distributed by Alibaba, have shown that fintech is not solely about start-ups, but can be about disruptive business models developed by existing companies taking a digital-first approach.

Mr Gulamhuseinwala says,"We monitor more than 20,000-plus fintechs through our proprietary database to help traditional players navigate the space and identify opportunities to invest and partner. We think that the number of new entrants will continue to increase substantially, but that the second wave is more likely to be established through non-financial services companies looking to attack the financial services activity chain to support their core business." TB

IS A COMPANY JUST USING THE INTERNET TO CREATE AN AGENCY MODEL, OR IS IT ACTUALLY BUILDING SUSTAINABLE ADVANTAGE VIA ANALYTICS? *Giles Andrews*

THE MILLENNIAL AUDIT
Restoring confidence

The auditing of financial institutions has changed little over many decades, but the combined forces of post-financial crisis regulatory reform and digitisation are transforming the audit world, writes Heather McKenzie.

One of the questions asked in the immediate aftermath of the financial crisis was whether auditors were 'the dogs that didn't bark', signing off on financial statements of institutions that later collapsed. To address these concerns, the European Commission (EC) has introduced new rules on statutory audit, which became applicable throughout the EU on June 17, 2016.

The reform aims to improve audit quality and restore investor confidence in financial information, an essential ingredient for future investment and economic growth, says the EC.

The main objectives of the reform are to:

- Ensure further transparency on the financial information of companies;
- Provide statutory auditors with a strong mandate to be independent and exert professional scepticism;
- Contribute to a more dynamic audit market in the EU; and
- Improve the supervision of statutory auditors and the coordination of audit supervision by competent authorities in the EU.

THE POWER OF KNOWLEDGE

Key measures include increasing the informational value of the audit report. For example, differentiation has been made between public interest entities (PIEs) and non-PIEs. PIEs are defined as all companies listed on an EU-regulated market and unlisted banking and insurance companies and groups, unless they are small.

The audits of PIEs will be required to report on key areas of risk of material misstatement of the annual or consolidated financial statements. In addition, statutory auditors must explain the extent to which the statutory audit was considered capable of detecting irregularities, including fraud.

The audit committee has been strengthened, with requirements for members to be independent and to have competence in the relevant sector. The committee will appoint the statutory auditor, or the audit firm, and will monitor the statutory audit, as well as the performance and independence of the auditor.

> COMPANIES WANT TO MAKE SURE THEY HAVE QUALITY ASSURANCE, THEREFORE BOARDS AND AUDIT COMMITTEES REALISE THEY HAVE TO PAY MORE ATTENTION TO THE QUALITY OF THE AUDITOR THEY HAVE
>
> ***Melanie McLaren***

Some financial institutions have used the same auditor for 50 years or more, and it is suspected that such a long-standing professional relationship could undermine an auditor's independence. The EC believes mandatory audit firm rotation will help reduce "excessive familiarity" between the statutory auditor and its clients, limit the risks of carrying over repeated inaccuracies and encourage "fresh thinking", thus strengthening the conditions for genuine "professional scepticism". PIEs will be required to change their statutory auditors at least every 10 years.

LEVEL PLAYING FIELD

The amended directive also encourages the development of a level playing field for audit firms at EU level to foster "more dynamic and open audit markets". It established a 'European passport' for audit firms to facilitate cross-border mobility within the EU and strengthen the single market for audit.

"We expect the EU's reform to create a more robust audit process that enhances the quality of statutory audits in Europe," says one EC official. "Several of the key elements of the reform should enhance audit quality, including stronger public oversight of auditors, a stronger role for audit committees, more stringent requirements to promote the independence and professional scepticism of auditors and extended reporting by auditors."

Vincent Roty, EY partner and audit innovation leader for Europe, the Middle East, India and Africa (EMEIA) financial services, says: "The financial crisis and the regulatory response to it, such as the EU audit reforms and the changing public expectations of financial services, indicate that the time is right to reconsider the purpose of an audit. Audit is becoming less likely to be viewed as a compliance activity. Today, the expectation is that audits should provide a level of comfort to all stakeholders, which include shareholders, regulators and the public."

This change in perception is important, he adds, because it will enlarge the scope of the audit to provide assurance not only on the financial statements, but also on other areas such as risk and valuation techniques.

As increased responsibility is placed on audit committee members and non-executive directors, they will ask how they can better challenge management of financial institutions, says Mr Roty. "This opens an opportunity for trusted third parties to add value to the audit process. Such third parties can provide insights into best practice in the industry and provide benchmarks, while

maintaining client confidentiality."

Melanie McLaren, executive director for audit and actuarial regulation at the UK's Financial Reporting Council (FRC), agrees that corporates are no longer viewing audits as solely compliance exercises. "There is now a focus on assurance and its value. Companies want to make sure they have quality assurance, therefore boards and audit committees realise they have to pay more attention to the quality of the auditor they have; it is not just a utility," she says.

DIGITISATION IMPACT

As the regulatory reforms to the audit process begin to influence long-established practices, the digitisation of financial services is further changing the audit landscape.

With the implementation of digital technology and big data systems, analysis can be undertaken on entire portfolios and data sets, rather than just a selection as is the case with sample-based audits, says Mr Roty. For example, the time saved in being able to automate parts of the audit will enable more value-added tasks to be undertaken, such as analysis, insights and Basel III model benchmarking.

"Greater assurance can be provided about what a bank's management says about its risk appetite and conduct throughout the group," he adds.

There is also growing demand for forward-looking audits and for discussions with management and the board of directors about emerging risks such as cyber and data security and quality. "The expectation is that auditors will provide a view on that, comparing the institution with others and assessing whether the risks are properly addressed in the statements," says Mr Roty.

BLOCKCHAIN BREAKDOWN

Innovative technologies, such as blockchain, have strengthened the argument for 'continuous audits'. A continuous audit enables independent auditors to provide written assurance on a subject matter, for which an entity's management is responsible, using a series of auditors' reports issued virtually simultaneously with, or a short time after, the occurrence of events underlying the subject matter.

Professor Dr Leen Paape, dean of Nyenrode Business Universiteit in the Netherlands, believes blockchain will reduce the need for traditional auditors and open the way for other skills to be included in an audit team.

"This won't happen overnight, but technology will help audits and lead to continuous monitoring. Data scientists will be required in an audit team to assure that the data is correct," he says. He believes the annual report will be obsolete in the next five to 10 years, replaced by continuous monitoring.

Hugh Harper, strategy and operations leader for EMEIA financial services at EY, says at present continuous audit validation, particularly with blockchain, is conceptual. Like Mr Paape, he believes any change will be "an evolution, not revolution".

Mr Harper believes that with new technology, some form of continuous monitoring and verification will occur alongside the core business system controls of the audit. However, when making longer term audit appointments today, the medium-term evolution in audit scope, practice and disciplines and an audit team's ability to lead and adapt in this environment are new considerations for audit committees.

THE AUDIT OF THE FUTURE

In seeking to make financial institutions more transparent, financial regulators have created a paradox as audits become much more complex, says Mr Paape. "In demanding that financial institutions become more transparent, we may create all types of systems that will make it very complex so that people at large don't understand what is in the audit report," he says.

He cites the International Financial Reporting Standard 9 (IFRS 9) regulation that was recently endorsed by the EC. The reporting standard is mandatory from January 1, 2018 and comprises classification and measurement, impairment and hedge accounting. Unlike hedge accounting under IAS 39, the new standard enables companies to better reflect their risk management activities in their financial statements.

"Auditors should not just ensure the annual report is more helpful for stakeholders, I would like to see them also ensure the information is more relevant; they should look at the company as a whole," says Mr Paape. An alternative is to audit 'in control' statements that describe the risk management and control systems of organisations. This, however, would involve a lot more work on the part of the auditor, he says.

A QUESTION OF VALUE

Isabelle Santenac, assurance services leader for EMEIA financial services at EY, says there is a big difference between the market value and book value of financial services firms, which suggests the markets are pricing risk or intangibles that are not at present part of financial statements and therefore »

WE BELIEVE THERE IS A NEED TO DELIVER BROADER ASSURANCE ON ELEMENTS THAT ARE NOT REFLECTED IN FINANCIAL STATEMENTS, BUT ARE IMPORTANT FOR STAKEHOLDERS, IN PARTICULAR IN FINANCIAL INSTITUTIONS

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THE FINANCIAL CRISIS AND THE REGULATORY RESPONSE TO IT, SUCH AS THE EU AUDIT REFORMS AND THE CHANGING PUBLIC EXPECTATIONS OF FINANCIAL SERVICES, INDICATE THAT THE TIME IS RIGHT TO RECONSIDER THE PURPOSE OF AN AUDIT *Vincent Roty*

not audited. "We believe there is a need to deliver broader assurance on elements that are not reflected in financial statements, but are important for stakeholders, in particular in financial institutions," she says.

For example, the regulatory capital ratios set out in the Capital Adequacy Directive are important measures but are not part of an audit review. "The capital, liquidity and leverage ratios are more important for investors and regulators than the pure financial statements," says Ms Santenac.

Regulators focused on these ratios following the financial crisis as they sought to strengthen the capital and liquidity of banks. In turn, banks have had to significantly change the way they manage their capital and liquidity. For auditors to remain relevant, says Ms Santenac, they must assess and provide assurance on matters that are important to stakeholders, which includes investors, regulators and the general public.

The EC official says the regulator is aware there is a debate about an "expectations gap" in audits. "Certainly, auditors must thoroughly understand the audited entity's business model, risk appetite and so on. This is particularly important for audits of financial institutions. However, the audit remains focused on the financial statements," the official adds.

"Having said that, the extended audit report and the additional report to the audit committee required for PIEs require that auditors address a broad range of relevant matters, including significant risks of material misstatements, an assessment of valuation methods applied to items in the financial statements and a report on any deficiencies in the audited entity's internal financial control system."

FORWARD LOOKING

Accounting standards such as IFRS 9 are encouraging auditors to take a more forward looking view of credit risks, for example, which will require auditors to include more credit risk specialists in their teams. "The trend in audit is to broaden assurance, going beyond the financial statements," says Ms Santenac.

Ms McLaren also cites the more forward-looking element of audits as important. "Audits are not done in a vacuum and the issue to be addressed is whether an auditor is looking at the right things, particularly non-financial aspects. The concept of strategic reporting has emerged as stakeholders not only need historical information in the financial statements, but also on a company's prospects," she says.

The FRC, through its UK Corporate Governance Code, has introduced a requirement for directors to provide a viability statement that sets out how long they reasonably expect the business to be able to set its liabilities as they fall due. For banks there are special considerations and so the FRC has developed supplemental guidance. There have also been other reporting developments to promote more transparency between audited financial statements and the reporting tied to capital adequacy.

"The regulatory Pillar Three information is in the public domain but there is no obligation for it to be audited. However, an auditor must make sure that information is consistent with the understanding it has gained through auditing the financial statements," says Ms McLaren.

TRANSFORMING THE MARKET

Until a few years ago, there was not really an audit market – the level of rotation of audit firms was low and usually stimulated by a merger and acquisition event or for some independence issue. Regulatory reforms, digitisation of the financial services business model and greater social interest in financial services firms are beginning to reshape the nature of the assurance sector.

Mr Harper says "almost overnight", stakeholders and clients have placed a greater focus on the audit selection and design. Efficiency and transparency are being improved and there has been a "maturing of understanding" of what firms want in an auditor and how to "buy" an auditor.

He adds: "In 10 years, an audit will look very different to what it does today because business systems are changing, as is the nature of risk that is being evaluated in an audit. This will require a new set of disciplines in audit teams, covering areas such as cyber risk and data science. Audits will become even more multi-disciplinary, expertly architected to combine broad skills and expertise. The days of the generic audit and general auditor are truly becoming a thing of the past."

The EC official says the retendering and rotation has forced auditors to rethink how they deliver value and quality to their clients, adding: "Audit committees bear an important responsibility to ensure that the new audit legislation works as intended. They need to act as the guardians of the auditor's independence and ensure that auditors can effectively perform their duties. Many large financial institutions have long-standing and professionally run audit committees but this is not yet the case for all financial institutions." TB