HYPERFINANCE

ACCELERATING DIGITAL INNOVATION IN FINANCIAL SERVICES

Simmons & Simmons

ARE YOU READY FOR HYPERFINANCE?

There is a revolution under way in the financial services sector, and it is accelerating innovation at a startling pace

Innovation is disrupting almost every link in the financial services value chain: from the emergence of automated investment services in wealth management, to the advent of new digitally-enabled business models such as crowdfunding, and increasingly intelligent regulatory software.

A rapidly expanding universe of FinTech start-ups in these and other areas has attracted growing investment over the past few years, with global FinTech investment reaching a record high of $46.7bn in 2015.[1] And while overall FinTech investment dipped to $24.7bn in 2016, corporate venture capital activity was actually up, as banks, asset managers and others sought to on-board innovation being spearheaded by FinTechs.

This disruption poses a very real threat to the incumbents' status quo, but prescient banks and asset managers are working out how to fast-track their own innovation and best institutionalise emerging technologies to seize competitive advantage.

'**Hyperfinance**' is a flagship research programme from Simmons & Simmons. The programme, undertaken in partnership with Longitude Research, investigates how large banks and asset managers are accelerating their digital innovation.

The findings explain the challenges financial institutions and asset managers are experiencing as they seek to accelerate their innovation, and they also show where improvements can be made. Most importantly, the research tells us **how the industry's leaders are adapting their innovation strategies to reach hyperspeed**.

JEREMY HOYLAND
Managing Partner,
Simmons & Simmons

1. The Pulse of FinTech Q4 2016, KPMG, 21 February 2017

CONTENTS

KEY FINDINGS

FIRST-MOVERS CAN BE FAST MOVERS

Only a handful of financial institutions and asset managers can claim to be setting the pace in digital innovation. Just 7% of our survey respondents feel that the bank or asset manager they represent is industry-leading in digital innovation. A stark acknowledgement that large firms struggle to act as first-movers. The rewards for those able to accelerate innovation, however, could be huge.
(See Page 9)

INNOVATE TO GROW

The most innovative institutions are more likely to have grown revenues and seen better returns from new products. Of the firms that are ahead of their peers in digital innovation (‘Innovation Leaders’), 79% report some level of revenue growth over the past 12 months versus just 49% of other respondents. What is more, 80% of Innovation Leaders say the digitally-driven products and services they have launched over the past three years have opened up new revenue growth, versus 49% of other respondents. **(See Page 10)**

NOT EVERYONE IS FINTECH-READY

Collaborating with FinTech firms is integral to innovation, but most large institutions are poorly equipped for this. Three-quarters of respondents accept they need to improve partnerships with outside firms, such as FinTechs, to accelerate innovation. Yet, they are not geared up for such collaboration, with complex decision-making processes and their approach to intellectual property causing problems. And only 19% consider their procurement processes to be ‘highly effective’ in enabling collaboration with FinTech firms. **(See Page 13)**

REGULATORY RISK COULD HAMPER INVESTMENT

There is an appetite to acquire the right FinTech firms, but regulatory risk is a serious concern. Nearly one third of respondents (31%) expect to acquire a FinTech firm within the next 18 months. Of the remaining two thirds, 45% cite concerns about regulatory risk as a key deterrent. Meanwhile, as the FinTech sector matures, leading banks are establishing strategic investment units to beat the competition to the best start-ups – and to gain the first-mover advantage in on-boarding new technology. **(See Page 24)**

CYBER INSECURITY

Cybersecurity risks are the biggest barrier to better partnering. Nearly three-quarters (71%) of respondents report that cybersecurity is the most significant risk associated with partnering with FinTech firms. This reflects the sector's stringent data protection and compliance requirements – and the financial and reputational cost of any lapse. **(See Page 17)**

CONSORTIA CONUNDRUM

Industry consortia are vital, but the model needs refining. The industry recognises the need for consortia to implement certain new innovations, such as distributed ledger technology. However, 60% of respondents think some existing consortia are ineffective because they have too many participants, and 68% say they would need a high level of control over the direction of a consortium to participate. **(See Page 20)**

HOW TO GO HYPER

Six steps to faster digital innovation

ESCAPE THE ‘FOUR WALLS’

Whether it’s creating a separate legal entity, or establishing an innovation lab within a start-up ecosystem, freedom from the constraints of organisational processes and culture can be hugely beneficial to accelerating innovation and collaboration with other partners. Engaging carefully with the main organisation can help to ensure that the unit’s innovation is a commercial success. **(Page 30)**

ADAPT THE ON-BOARDING PROCESS

Large institutions can speed up the on-boarding of FinTech firms by adopting a more flexible and tailored approach. Legal and compliance must be ready to use a ‘lighter touch’ for lower-risk collaborations with FinTech firms. **(Page 13)**

GET PRAGMATIC ABOUT IP

A flexible approach to IP structuring is crucial. Licensing arrangements are increasingly important to FinTech firms’ innovation in certain areas, while banks and asset managers that are comfortable with licensing structures can become early adopters – and gain further benefits. **(Page 13)**

CENTRALISE YOUR DIGITAL INNOVATION STRATEGY

As FinTech firms become more diverse in their activities and new FinTech hubs emerge globally, multinational banks and asset managers need a coordinated plan of attack to stay abreast of new technology. A centre of excellence or centralised knowledge base is key for efficiently marrying the right innovations with the needs of the business. **(Page 22)**

KNOW YOUR PARTNERS

When carrying out due diligence on a potential FinTech partner, there is no substitute for spending time getting to know the founders and other senior staff in person. Asking the founders to describe their technology development cycle and their approach to compliance gives a much clearer view of the risks presented by an early stage business. It works better than asking them to fill in a 200-page procurement questionnaire and provide a raft of policies they may never have read. **(Page 13)**

PICK THE RIGHT INVESTMENT MODEL

Outright acquisition of FinTech businesses could quash innovation, as firms might need to work with multiple players to develop cross-industry solutions. Taking a minority stake in a FinTech firm bypasses this risk, enabling financial institutions and asset managers to get closer to the development of the technology. **(Page 22)**


N P 3 C
Q 7 W S
F G 9
A R

ON THE LAUNCHPAD:

Are innovation strategies working?

The rapid growth of the FinTech sector since the financial crisis is forcing incumbent institutions to solve a new problem: how can large, complex financial organisations significantly accelerate their pace of innovation?

Nimble competitors are emerging across the industry to disrupt the value chain: whether they are challenger banks such as Monzo, investment platforms such as Betterment, or innovative lending platforms such as Funding Circle.

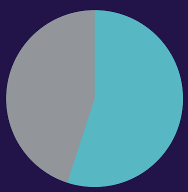
The meteoric rise of these firms poses a material threat to traditional banks and asset managers – if they don't take decisive action. "The bleak dystopian view for banks is not just the idea that they become the 'dumb pipes' that carry out payment transactions. It's the idea that they might become the 'dumb capital'. Holding money and lending it out, while more tech-savvy businesses control the customer engagement layer," says Dean Nash, Head of Legal & Compliance at Monzo.

However, large banks and asset managers are not standing still. Our research highlights some of the ways in which they are responding to this potential threat.

FIGURE 01

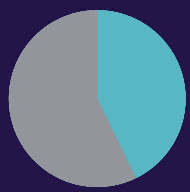
ACCELERATING INNOVATION

Which of these approaches has your organisation used in the past three years to help improve its digital innovation capability?



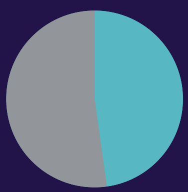
55%

Investing in building our own in-house expertise



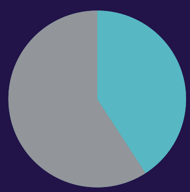
43%

Setting up our own new business units to deliver a specific FinTech product



48%

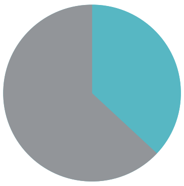
Collaborating or partnering with FinTech/ innovative firms



41%

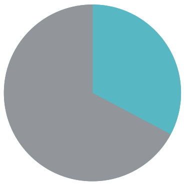
Setting up accelerator or incubator programmes for FinTech/innovative firms

Source: Simmons & Simmons, 'Hyperfinance' research, 2017



37%

Establishing joint ventures (JVs) with FinTech/ innovative firms

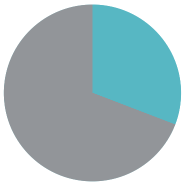


33%

Corporate venturing

33%

Joining consortia projects with other financial services institutions (e.g. R3)



31%
Acquiring FinTech firms/start-ups

There is widespread innovation activity among our respondents, with many pursuing multiple strategies to accelerate their innovation. The problem is that they are struggling to achieve the best outcomes from their innovation strategies.

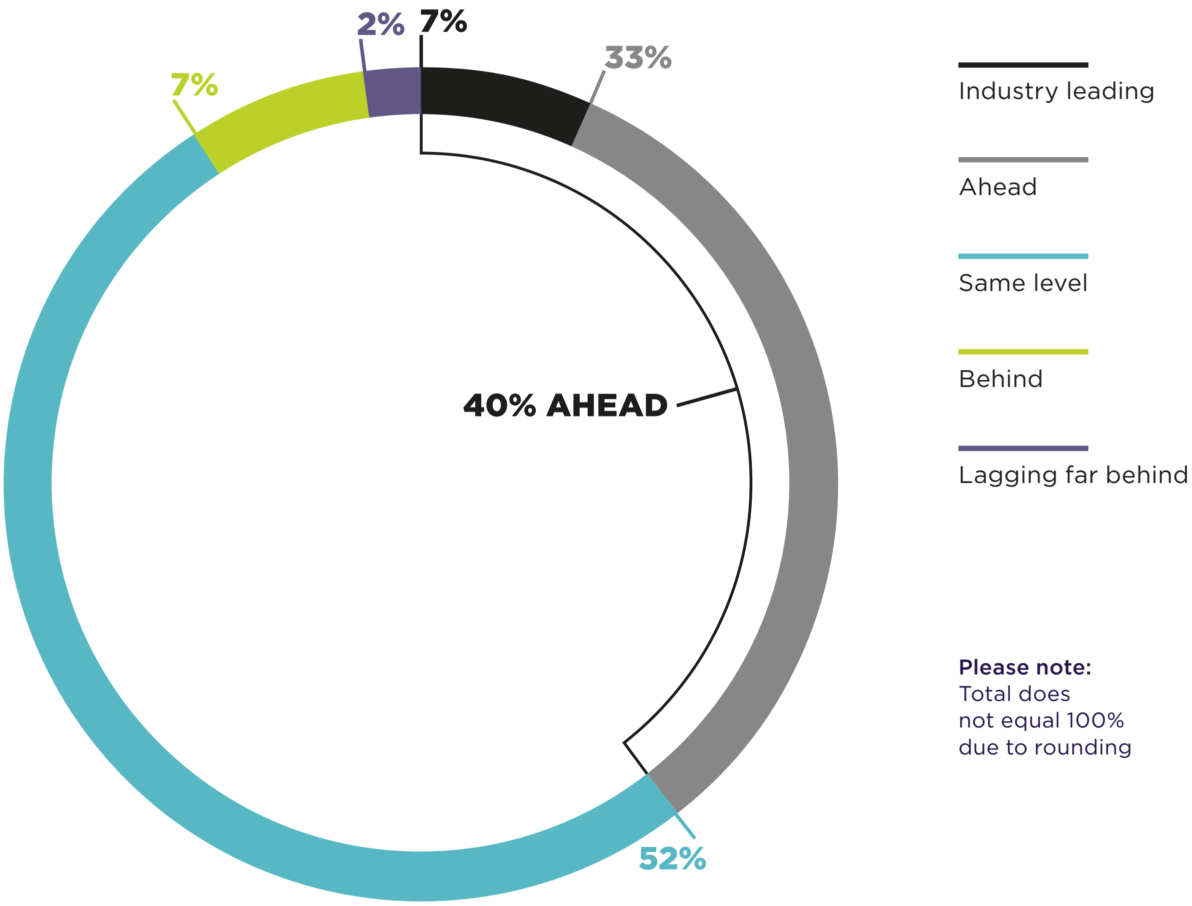
INNOVATION STRATEGIES ARE FALLING SHORT

Only 7% of our respondents feel their institution is industry-leading in digital innovation. Overall, however, two-fifths describe themselves as ahead of industry peers to some degree.

FIGURE 02

STEALING THE FIRST-MOVER ADVANTAGE

How would you describe your institution's current level of digital innovation versus rival banks or asset managers?



Please note: Total does not equal 100% due to rounding

This 40% is our group of Innovation Leaders. Who describe themselves as more digitally mature than other organisations across their front, middle and back offices.

Source: Simmons & Simmons, 'Hyperfinance' research, 2017

	INNOVATION LEADERS	INDUSTRY MAJORITY*
Launched 5+ new digitally-driven products (e.g. robo-advisory, payments app, peer-to-peer lending)	**60%**	**17%**
Implemented 5+ new digital middle/back-office solutions (e.g. RegTech solution)	**44%**	**16%**
Increased total revenue over past 12 months	**79%**	**49%**

Source: Simmons & Simmons, 'Hyperfinance' research, 2017

The Innovation Leaders' ability to maximise returns from breakthrough strategies creates a clear distinction between them and the industry majority. In seizing the initiative, the Innovation Leaders are putting themselves in a strong position to gain first-mover advantage.

*Industry Majority refers to the 60% of respondents who are not in the Innovation Leader group

FIGURE 03

STRUGGLING TO OPTIMISE

To date, how effective have your organisation's approaches been in improving digital innovation?

(Percentage reporting each strategy as 'highly effective')

Source: Simmons & Simmons, 'Hyperfinance' research, 2017

For the industry majority, however, strategies for accelerating digital innovation are falling short.

For instance, only 16% consider their collaborations with FinTech firms to be highly effective.

> "Most banks' processes and IT estates have not changed one iota. Their compliance processes are still very manual and disconnected. Their APIs (application programming interfaces) are not really geared to deliver proper access. So it's this legacy complexity that is making it very difficult for FinTechs to work effectively with banks."

Nigel Verdon, CEO and Co-founder of Railsbank

Established players are not going to transform into agile innovators overnight. But it is clear that a minority of industry leaders are enjoying more success than most. What can the rest of the industry learn about the tactics these leaders are using to improve outcomes?

THE TRUTH ABOUT COLLABORATION

Building in-house FinTech expertise is the most popular approach of survey respondents. 55% are already doing this. But this is a long-term strategy. With Hyperfinance at the door, incumbents recognise the need to move faster. It is unsurprising then that their second-choice strategy – cited by 48% – is to partner with FinTech firms.

Once viewed predominantly as a threat to banks and asset managers, FinTech firms are now recognised as essential innovation partners.

ARE PARTNERSHIPS WORTH THE RISK?

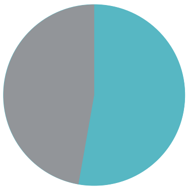
Pairing sophisticated, highly-regulated multinationals with small, fast-evolving start-ups creates clear challenges and risks.

The majority of our respondents acknowledge that they are poorly equipped for collaboration with FinTech firms:

FIGURE 04

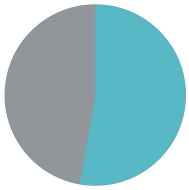
PARTNERING MISMATCH?

To what extent do the following factors create challenges for your institution's collaboration with FinTech firms?



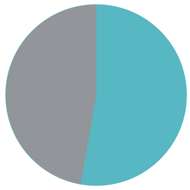
54%

Concerns about achieving the required return on investment (ROI)



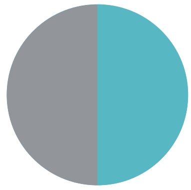
54%

Aligning different organisational cultures/ways of working



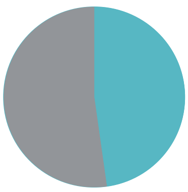
53%

Institutional rules limiting our ability to provide services to FinTech firms



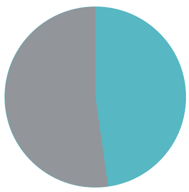
50%

Complexity of our decision-making structures



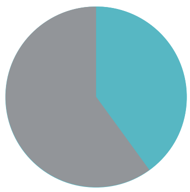
48%

Institutional desire to own IP rather than be satisfied with a licence



48%

Establishing allocation of liabilities or risks



40%

Our procurement processes

In addition, large numbers of respondents are concerned about inherent risks of collaborating with the FinTech sector: risks such as cybersecurity (71%), and uncertainty about the regulatory status of potential partners and their activities (51%).

Our research shows, however, that these challenges are not insurmountable.

Source: Simmons & Simmons, 'Hyperfinance' research, 2017

MANAGING INTELLECTUAL PROPERTY

Around half (48%) of our survey respondents say that there is an institutional desire to own the intellectual property (IP) when working with FinTech firms. This can stand in the way of effective collaboration.

Gary Chu, Global Lead Lawyer for UBS's FinTech Innovation Lab, argues that the industry should move away from a mindset where institutions always feel the need to own IP outright. This is because it can sometimes be counterproductive for innovation models that are based on cooperation, which is especially important in the distributed ledger technologies space.

> "At UBS, we see the value of IP as a key source of competitive advantage. And we'll protect it to further our strategy. But in working with third parties such as FinTechs or other banks, we recognise the core interests of our collaborators and seek to be creative in how we allocate and manage ownership of IP.
>
> For example, we can own IP but still grant broad licences. Or we can allow a third party to own it and seek broad enough licences for us to do what we need to do. There are other possible variations on this theme."

Gary Chu, Global Lead Lawyer for UBS's FinTech Innovation Lab

INTELLECTUAL PROPERTY IN THE HYPERFINANCE ERA
WHY PRAGMATISM TRUMPS PROPRIETORSHIP

Angus McLean, IP Partner and Head of FinTech at Simmons & Simmons, explains why institutions that are pragmatic about IP ownership will be rewarded.

Q **WHEN DOES IT MAKE SENSE FOR A LARGE INSTITUTION TO FORGO OUTRIGHT IP OWNERSHIP?**

A "Firstly, a bank or asset manager needs to consider IP in the context of its main objective for the partnership. On one hand, if you're seeking to launch a specific service, or solve a particular business problem, there's a good case for acquiring the IP outright. On the other hand, if you're seeking to access state-of-the-art technology, perhaps in an area such as RegTech, it may be critical that the third party has the freedom to work for multiple industry players, so they can continue taking the technology forward. Licensing would then make more sense, as taking outright ownership makes it very difficult to motivate the business to develop that technology stack further."

Q **HOW CAN A BANK OR ASSET MANAGER THEN MAXIMISE THE VALUE OF THAT LICENCE?**

A "Being the first institution to license a FinTech firm's technology can deliver strong competitive advantages, if the agreement is structured effectively. You may be able to negotiate a discounted royalty rate or licence fee. In some instances, you could insert more stringent obligations granting access to new releases developed by the licensor, and perhaps encourage the FinTech firm to develop some bespoke components for you. As a first-mover, you also get to understand the technology better than your competitors and can take more control over the direction of its development."

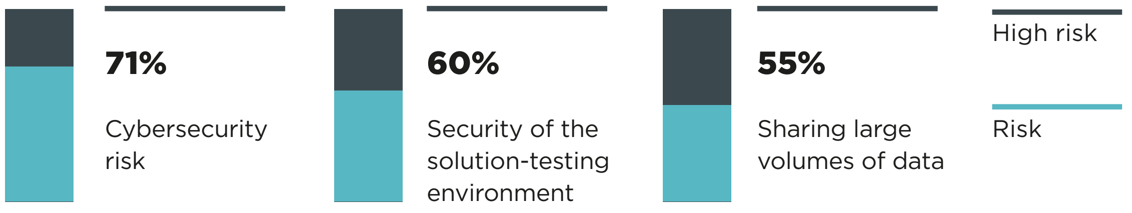
CYBER INSECURITY

> The partnering risk that our survey respondents are most concerned about is the threat to data security.

FIGURE 05

THE CYBER CONUNDRUM

To what extent would these areas pose a risk to your business if collaborating?



This level of concern is unsurprising. The direction of regulatory travel – the European Commission's General Data Protection Regulation (GDPR) and revised Payment Service Directive (PSD2) both come into force in 2018 – means that financial institutions and asset managers must devote greater resources to data governance over the next few years.

"There is a real economic imperative to share data with partners to help provide better services to customers," says Robert Allen, Financial Markets Litigation Partner at Simmons & Simmons. "But it does carry risk. Financial services institutions could face legal liability as a result of a security breach. There is also the reputational impact that would arise. So you really need to trust the people you are sharing data with. This means that carrying out technical and legal diligence on potential partners will be key."

In our survey, 56% of respondents say that they would be able to collaborate with FinTechs better if the firms were more transparent with their data protection compliance. "I think technology providers can become savvier about the assurances the banks need, such as being able to detail exactly where data is being held," says Diana Paredes, CEO and Co-founder of Suade Labs.

Barclays' Andrew Dentice, a FinTech specialist in the Operations, Technology and Commercial Legal team, says the bank is now placing more of a focus on cybersecurity in its contracts with third-party vendors. "A lot of the focus is on the procedural elements of a cyber-incident," he says. "If you're relying on standard confidentiality provisions, or data protection provisions, then it's quite a blunt instrument. It's actually really helpful if a contract sets out what your partner has to do and what it has to provide you with if an incident occurs. Whether it's shutting down systems, providing you with access to audit, or enabling you to reclaim data."

Alex Brown, Partner and Head of TMT at Simmons & Simmons, notes other practical steps that should be considered too: "I think it's also key to perform more robust due diligence and security audits of the FinTechs upfront, including penetration testing. So you can work out where the vulnerabilities are before you enter into an arrangement," explains Brown.

Source: Simmons & Simmons, 'Hyperfinance' research, 2017

ON-BOARDING AND THE PROCUREMENT OBSTACLE COURSE

Procurement processes are a major stumbling block in the bid to become agile and achieve first-mover advantage. They can be frustratingly complex and slow.

THE COMPLIANCE QUAGMIRE

Railsbank's Nigel Verdon believes the main problems in procurement are legacy compliance processes, and a lack of alignment between compliance and the commercial objectives of the business. "Compliance processes have been stacked up over time in response to the financial crisis, but now what banks have is a complete quagmire," he explains.

Verdon says that FinTech firms in areas such as payments or foreign exchange will be classed as high risk by the financial services institutions. "The fact that they might be licensed by the FCA (Financial Conduct Authority) means nothing," he explains. "Because if money laundering runs through it, and the bank processes it, it's clear whom the regulator will target.

PROCUREMENT AND PRODUCT GOVERNANCE

For a large bank or asset manager to move beyond the development stage and embed a FinTech firm's solution into its product set, there are a host of requirements that can't be circumvented. "You can make the legal terms as simple as you like if you are prepared to absorb the liability if the proposition fails. But if you want a proposition to be distributed to a traditional bank's customers, it has to comply with some fairly entrenched schedules of security and operational standards," says Monzo's Dean Nash. "You can't carve out a different risk appetite for a new business when it's all part of the same corporate entity. The way around it is to create a different entity, which is beholden to a different set of standards, or somehow carve out a department that plays by its own rules."

Part of the problem here is that for a new solution to be launched, both the procurement process and the product governance process must be completed. But the two are rarely well-coordinated. Sophie Lessar, Retail Finance Managing Associate at Simmons & Simmons, notes the importance of engaging legal early on to improve product outcomes. "If you have a situation where developers come up with a product and then ask legal to add the relevant wording, it's going to make it clunky and that will defeat the purpose of the innovation," she says. "If you understand the legal requirements from the outset, you can make sure you meet them while still creating a user-friendly experience for the end-consumer."

TOWARDS AGILE PROCUREMENT AND BEYOND

Our research suggests a set of best practices for procurement:

01. A FLEXIBLE MODEL

Tailor on-boarding requirements based on the type of engagement, streamlining these for smaller, lower-risk projects.

02. A TWIN-TRACK APPROACH

Undertake procurement and product governance processes simultaneously, avoiding delays by answering legal and risk questions at the outset.

03. COORDINATED FUNCTIONS

Close working relationships between innovation teams and commercially savvy legal, risk and governance professionals can speed up on-boarding and save headaches down the line.

04. EDUCATED PARTNERS

FinTech firms with former bankers at the helm may have a distinct advantage when it comes to faster on-boarding. Large institutions will be able to move faster when FinTechs understand the assurances they need on areas such as data security, and make this information readily available.

STREAMLINING THE CONSORTIA MODEL

With several banks recently removing themselves from the prominent R3 blockchain consortium,[2] it is important to question the existing model of industry consortia.

Respondents overwhelmingly recognise the value of working with industry consortia to develop certain digital solutions, such as distributed ledger technologies, with 72% citing this as vital. On the other hand, 60% believe that many consortia involve too many organisations to be effective.

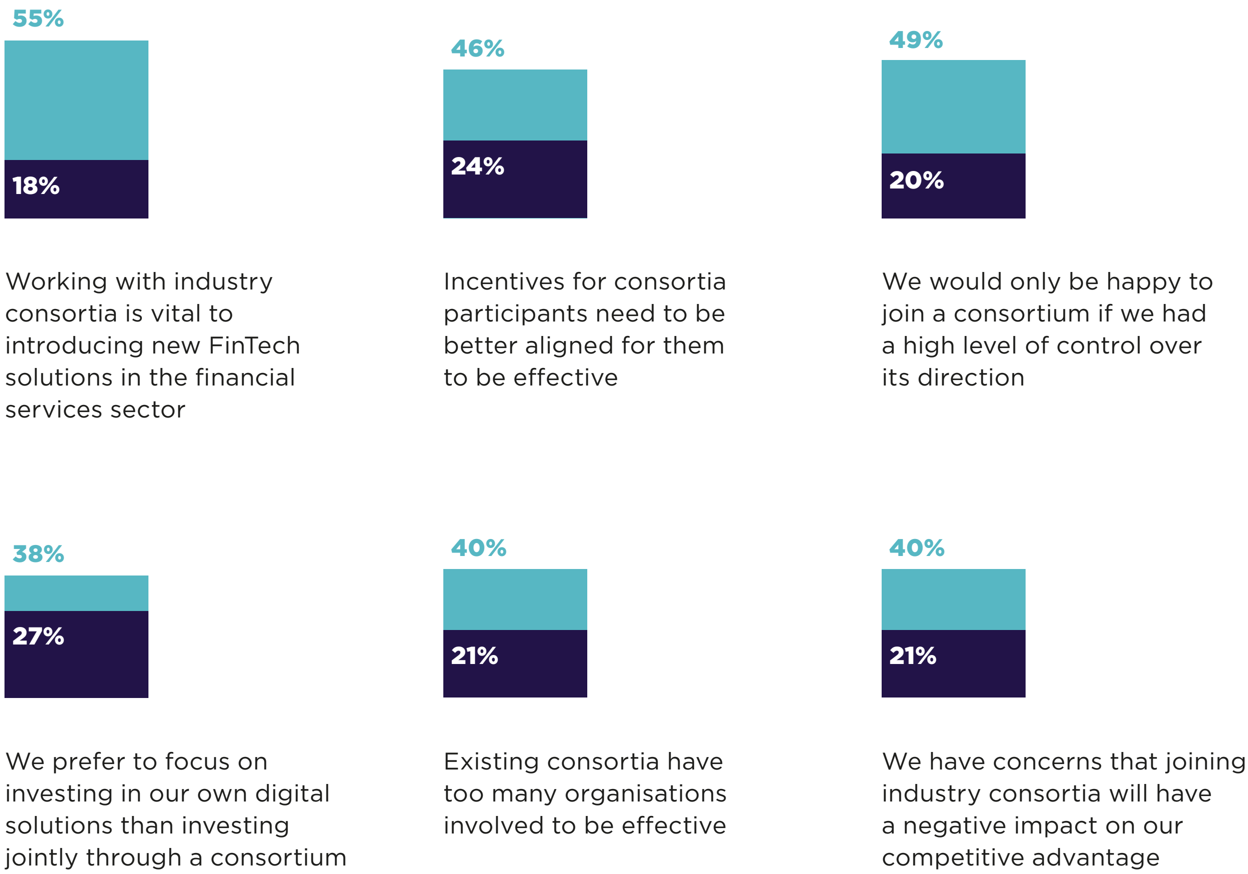
FIGURE 06

THE PROS AND CONS OF CONSORTIA

To what extent do you agree with the following statements about consortia projects?

Agree

Strongly agree



Source: Simmons & Simmons, 'Hyperfinance' research, 2017

2. Goldman Sachs and Santander have left a major blockchain group, City A.M., November 2016

"I think a practical point arises as to whether large consortia are the best vehicles for developing innovative technology. You need agreement on everything from prioritisation of projects for exploration to IP ownership, and the constitution of the consortium can become very unwieldy if there are more than four or five parties involved."

Angus McLean, Simmons & Simmons

Our survey results suggest the industry would like to see smaller consortia, better alignment of incentives for consortia members, and a high level of control over the consortium's direction of travel. But there has to be a balance. For distributed ledger-based solutions, for example, there is little point in having systems that work for only a small segment of the industry. The value is generated by enabling a network effect.

Perhaps a good archetype is the way UBS and other consortium banks are approaching the development of the Utility Settlement Coin (USC): by starting small and then expanding over time.

"We've kept the USC consortium to five members at the current stage of development, to maintain focus and momentum, better achieved in a smaller group," says UBS's Gary Chu. "We'll need to get other banks on board as we build out the technology. For now, the fact that we have Swiss, Spanish, German and US banks as members helps us take account of different legal and regulatory perspectives. We recognise that if we want to roll out USC industry-wide on a utility basis, it needs to be workable from the perspective of major financial markets globally."

"Care is needed to ensure consortia arrangements do not give rise to technical or practical competition law issues."

Charles Bankes, Competition Partner at Simmons & Simmons

TO BUY OR NOT TO BUY?

Stealing a march through acquisition and venturing

Our survey results suggest a surprisingly strong investment appetite among banks and asset managers for the next 12 to 18 months. 32% expect to undertake corporate venturing focused on the FinTech sector. 31% expect to acquire a FinTech firm during this time.

MARKET MATURITY AND THE DESIRE TO ACQUIRE

Among respondents in New York, this appetite is stronger still. Two-fifths (39%) are eyeing up FinTech deals over this period, compared with just 29% in London and 21% in Hong Kong.

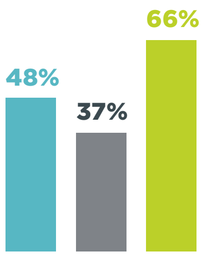
Ian Wood, who heads Simmons & Simmons' corporate and commercial practice for Asia, says that the market in Hong Kong is relatively immature in comparison with other financial centres. "There are a lot of start-ups, but many of them are not yet at a stage where they have shown themselves as a viable business, or proven their technology such that they make strong acquisition targets," he explains.

In Hong Kong and Singapore, 66% say that a lack of certainty about the best targets is spoiling acquisition appetites. It is the region's top barrier to acquisition. For New York-based respondents, however, the biggest concerns are regulatory risk and the potential for culture clash, with 53% citing these reasons.

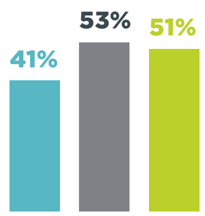
FIGURE 07

DETERRENTS TO ACQUISITION

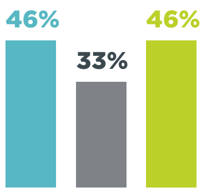
What are the main reasons why your organisation will not choose to acquire a FinTech firm in the next three years?



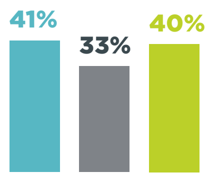
We are delaying acquisitions until we're more certain about the best target



We are concerned it would create a culture clash in our organisation



We don't think acquisition is the best route to improving our digital innovation

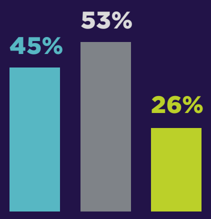


We are put off by uncertainty about intellectual property (IP) ownership

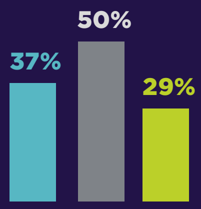
Total

New York

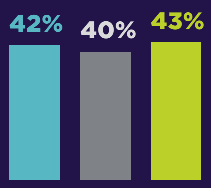
Hong Kong & Singapore



The regulatory risk
is too high



FinTech valuations are too
high / unrealistic



There is a lack of available
capital for such an acquisition

Source: Simmons & Simmons, ‘Hyperfinance’ research, 2017

REDUCING ACQUISITION RISKS WHILE GOING HYPER

Penny Miller, Financial Services Regulation Partner at Simmons & Simmons, says the relative infancy of the FinTech sector, and a regulatory framework that isn't tailored to emerging FinTech business models, creates challenges for institutions and asset managers seeking to understand the regulatory position of a business.

> "Some FinTech businesses also operate in newly regulated areas where there is a patchwork of new (and untested) regulation across different jurisdictions. A key area of risk mitigation is, therefore, to ensure that the FinTech business has a clear understanding of the regulatory landscape in which it sits and a strong compliance culture. Ideally, you also need advisors who understand how both new and existing regulations are being interpreted and applied by the regulators in this constantly evolving area."

Penny Miller, Simmons & Simmons

For those organisations that are seeking to acquire FinTech firms, there are a number of measures that can be taken to help minimise the risks involved:

01. REGULATORY STATUS

In a sector where both innovation and regulation are changing fast, it is vital to establish whether a FinTech firm's founders understand its regulatory status. Has the FinTech firm taken advice or consulted the relevant regulatory bodies in its market?

02. IP POSITION

There are several potential pitfalls linked to IP. FinTech founders commonly originate from financial institutions or software houses. So there is always a risk that software code, or information that qualifies as trade secrets, may have been brought into the firm from previous employers. Face-to-face interviews are a key tool for uncovering the likelihood of residual risks. It really helps you understand how the business has grown and the speed at which the firm has developed its technology.

03. EMPLOYMENT RISK

In a bid to spur on rapid growth, FinTech start-ups are often on the hunt for good enterprise software developers, who understand what banks and asset managers are looking for in new technologies. With a limited pool to draw from, FinTech founders may naturally be tempted to poach previous colleagues. This brings with it the risk of claims from former employers for breaches of restrictive covenants.

04. MARKET-WIDE SOLUTIONS

For some FinTech firms, the ambition for their innovation may be to create industry-wide solutions. For example, some firms developing blockchain-based solutions have the potential to become a core part of the financial services industry's infrastructure. This may bring unexpected regulatory burdens. Before acquiring such firms, large institutions will need to assess the current and future regulatory status of the business and technology in question. They should also consider whether investing in or acquiring the business could inhibit the number of other banks and asset managers that will adopt the technology.

A FOCUS ON VENTURING

Our survey results show that banks and asset managers prefer corporate venturing to outright acquisition of FinTech firms.

The approach has several advantages. It is lower risk, given that less capital is required. At the same time, institutions can choose how closely they want to engage with the target firm. This helps to control, where appropriate, the direction of technology development. However, the firm usually retains the flexibility to connect with other institutions (including the investor's competitors). It is the better option if the investor sees a benefit in the target firm continuing to do business with other financial institutions or asset managers.

> "We want the companies that we invest in to be innovative in their approach, technologies and platforms, and would expect these companies to have other financial institutions as customers. That's one of the reasons we prefer to focus on taking minority stakes. We are also willing to co-invest with other banks and financial institutions, which is an innovative approach not just for us but for the broader financial services industry."

Ore Adeyemi, Director of HSBC's Strategic Innovation Investments unit.

HUNTING FOR FINTECHS: HOW HSBC IS GETTING AHEAD WITH ITS VENTURING UNIT

Ore Adeyemi, Director in HSBC's Strategic Innovation Investments unit, on how the bank is approaching corporate venturing in the FinTech sector.

1 TOP-DOWN APPROACH

In 2014, HSBC set up a Group Innovation unit to coordinate the bank's approach to understanding and on-boarding innovation. This unit was established and endorsed directly by the bank's Group Management Board. The Strategic Innovation Investments team is a key part of this, focused on venture capital investments. "There are people focused on digital innovation across many different parts of the bank, so we have implemented a structure which allows for a coordinated approach to the way we understand, capitalise on and drive the trends transforming our industry," explains Adeyemi.

4 KEY AREAS OF INTEREST FOR NEW TECHNOLOGIES

HSBC is targeting four specific areas in its hunt for FinTech investment opportunities:

- Security ('protecting the bank')
- Big data and analytics
- Open banking and client networks
- Operational efficiency ('improving the bank')

4 STEPS TO IDENTIFYING STRATEGIC VALUE

Each senior manager in the investment unit has internal business clients, helping them understand and focus on the business's innovation needs. FinTech investment targets must fulfil certain important criteria:

- Providing new insight
- Catalysing adoption
- Supporting the business
- Financial returns

3 CRUCIAL RISK ASSESSMENTS

Taking an equity stake in an early stage firm always carries risks, so these risk assessments are crucial in any investment decision:

- Business viability
- Evolving regulatory landscape for digital innovation in financial services
- Reputational risks

TOP TARGETS IN CAPITAL MARKETS FINTECH:
A VENTURE CAPITALIST'S TAKE ON HYPERFINANCE

Mark Beeston, Partner at Illuminate Financial, a venture firm focused on innovative technologies impacting capital markets, explains why capital markets players need to focus on the 'four Cs' to stay competitive.

Q **WHAT AREAS OF FINTECH SHOULD CAPITAL MARKETS PARTICIPANTS BE PRIORITISING FOR INVESTMENT?**

A "We are at a moment of generational change in terms of market infrastructure. The change driver is no longer the front-office quest for competitive advantage. It's about four factors: cost, control, capital and compliance. If you're not addressing those, you're going to be out of business."

Q **WHAT KINDS OF TECHNOLOGIES BEST MEET THESE CRITERIA?**

A "Though we're 10 years post-crisis, regulations such as Basel III and MiFID2 are only starting to bite now. Any technologies that can support the incremental requirements of new pieces of regulation, or that offer scalable models for process needs, represent interesting opportunities. Two businesses within our portfolio that are hitting clear and present regulatory and compliance challenges are CloudMargin and Privitar."

INNOVATING OUTSIDE THE MOTHERSHIP

Succeeding with accelerators and new business units

Our respondents report encouraging success in establishing new business units for FinTech innovation. Of those taking this approach within the past three years, 38% say it has been highly effective in improving their digital innovation. This puts it ahead of other strategies that firms are pursuing.

Creating a separate subsidiary or legal entity operating outside of the main business offers several distinct advantages:

PROCESS DESIGN
The potential to establish new processes. For instance, circumventing any unnecessary legacy compliance processes.

AUTONOMY
Innovation teams can be given more freedom to make decisions and accelerate development of new technologies.

IMPROVED COLLABORATION
Working outside the constraints of the main organisation may align the business culturally and procedurally with potential collaborators.

The Innovation Leaders in our survey have achieved their greatest success through new business units, or accelerator and incubator programmes. Diogo Garrido, Digital Innovation Strategist at Millennium BCP bank, is convinced that this is the right approach. “Banks need the firepower to transform how they serve their customers, and to bring new solutions to market much faster,” he says. “This means bringing the right FinTech talent into the business and putting the right environment around it. These new divisions represent the future of the bank. If you put these innovation labs inside the main organisation, it can destroy the lab."

THE SCIENCE OF INNOVATION: HOW UBS’S LEVEL39 LAB IS ACCELERATING BLOCKCHAIN R&D

In 2015, Swiss bank UBS set up an innovation lab at London’s Level39, Europe’s largest FinTech accelerator. Gary Chu, UBS’s Global Lead Lawyer for the innovation lab, explains how it is speeding up the bank’s development of distributed ledger technologies (DLT).

> “Situating our team in an environment which promotes creativity and disruption was a fundamental part of our strategy. It allowed us to easily collaborate with start-ups and financial institutions, which were active in the spaces we wanted to explore.”

Gary Chu, UBS

One of UBS’s most prominent collaborations in DLT is with Clearmatics, with which it has been developing the Utility Settlement Coin (USC) since 2015. Following a successful proof of concept, UBS has formed a consortium of banks for USC.

UBS’s approach to coordinating the lab with the main organisation is key to ensuring that its innovation delivers real value for the business. UBS coordinates the lab with internal advisory and control functions too. This can help avoid legal or compliance headaches linked to innovation, as well as smooth the collaboration process.

KEY STATS: HOW ASSET MANAGERS ARE APPROACHING HYPERFINANCE

Disruptive innovations such as automated investment advice are becoming more advanced. Investment flows into low-fee, passive investment vehicles are increasing. Regulatory and transparency requirements are deepening. So it's easy to see why the asset management sector is turning to FinTech solutions. Our survey assesses the innovation strategies that asset managers are pursuing, and where they stand out from the broader financial services industry:

INNOVATION STRATEGIES

When asset managers' innovation strategies over the last three years are compared with those of our banking respondents, we see that asset management firms have been:

- More active in establishing accelerators or incubators (47% vs.38%)
- Less active in setting up joint ventures with FinTech firms (30% vs. 40%)
- More focused on building in-house FinTech expertise (64% vs. 50%)
- Involved in considerable collaboration with FinTech firms – 50% have done this

DELAYING ACQUISITION

- Only a minority of asset managers (27%) have acquired a FinTech firm or innovative start-up over the last 3 years
- Of those that haven't pursued M&A, 55% are delaying due to uncertainty about the best target, while 53% say the regulatory risk is too high

EMERGING TECHNOLOGY

- Asset managers are more advanced in implementing data analytics engines than banking respondents (48% vs. 36% feel they've implemented this technology)

ACCELERATING INNOVATION

- 64% of asset managers say it's likely they will put in place new service level agreements with FinTech partners over the next 18 months
- 67% will work to improve alignment between innovation, procurement and legal teams to improve digital innovation
- 45% will introduce new measures to improve the security of the testing environment for new digital solutions

ABOUT THE RESEARCH

During January and February 2017, in collaboration with Longitude Research, we undertook a comprehensive programme of quantitative and qualitative research across the financial services industry

THE SURVEY

We surveyed 200 senior-level respondents – 30% at C-suite-level – from large banks and asset management firms

67% were banking respondents, and 33% were asset managers

Respondents covered five financial centres: Frankfurt (25%), Hong Kong (12%), London (25%), New York (25%) and Singapore (13%)

Respondents were drawn from roles in operations, IT, legal and compliance, and innovation/strategy

50% of respondents were from institutions with annual revenues of $1 billion+

THE INTERVIEWS

We conducted 16 in-depth interviews about digital innovation in the financial services industry with experts from banks, FinTech companies and Simmons & Simmons.

We would like to thank the following contributors for sharing their valuable insights for the research:

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