



**Unleashing the
potential of
FinTech in banking**



**Building a better
working world**

Contents

Executive summary	3
Partner or perish: actions for banks	6
Partner or perish: actions for FinTechs	14
Embedding FinTech in the banking ecosystem	20

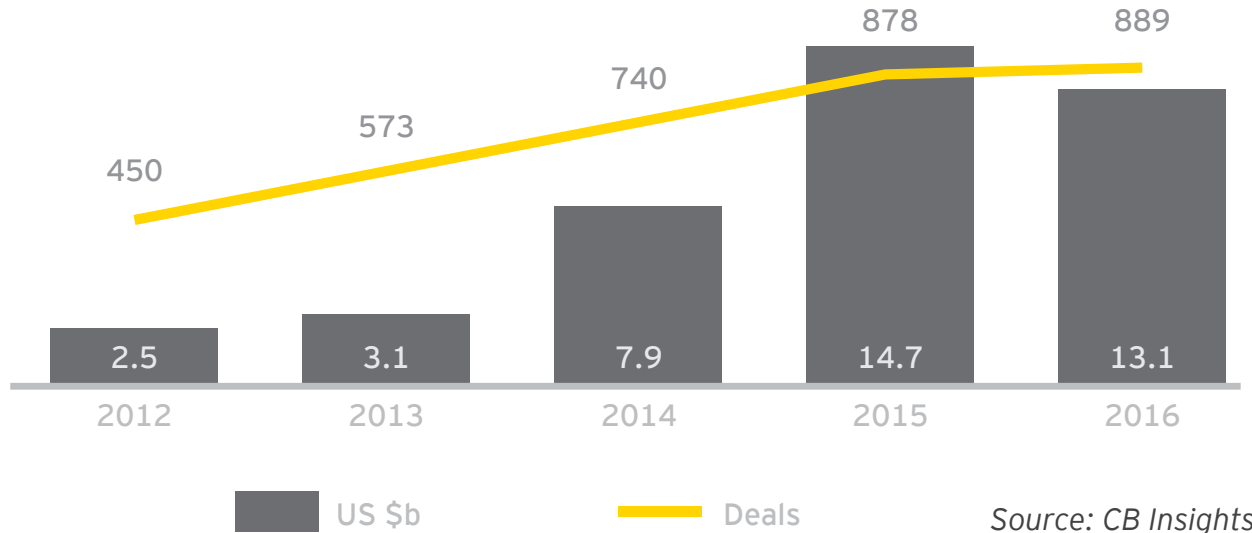


Executive summary

The FinTech industry attracted over US\$13.1b in VC-backed investments in 2016, about five times more than investments four years earlier (see Figure 1). The growth of the industry has strengthened the common belief that FinTech will disrupt banking. But collaboration – not competition – will be the primary driver of disruption.

The biggest near-term threat to most banks comes not from FinTechs but from traditional competitors better leveraging those FinTechs. Our analysis of 45 major global banks reveals that while all banks are engaged with FinTechs one way or another, only around a quarter are extensively engaged due to barriers to collaboration with FinTechs. In this report we look at some of the common barriers to effective collaboration – from navigating procurement and vendor risk management to technical implementation – and how banks and FinTechs can overcome them.

Figure 1: Annual global financing trend to VC-backed FinTech companies



EY FinTech Adoption Index¹ highlights the consumers' rapid uptake in recent years of financial services offerings from new innovative companies, while EY Global Consumer Banking Survey 2016 emphasizes how the accessibility of these new technologies appeals to customers and calls on banks to innovate like FinTechs. But it is not just on the front line of consumer banking that we see disruption.

Regulators see the benefits of – and, in fact, expect banks to use – regulatory technology (RegTech) to improve processes. Meanwhile, an array of rapidly advancing technological innovations, from robotics to artificial intelligence and machine learning, offer banks new ways to transform their businesses without replacing core banking systems.

Initiatives such as Open Banking in the UK and the Payments Services Directive II (PSD II) in Europe, combined with the EU's General Data Protection Regulation, as well as the development of commercial banking aggregator models – especially in the US – are giving customers more control of their data, held by banks.

At the same time, FinTechs increasingly recognize the significant costs of customer acquisition in financial services and barriers to cross-border business that banks are well-equipped to bridge. Furthermore, more emerging FinTechs recognize the opportunity to have a role as part of a broader banking ecosystem, developing technology that can help transform an industry, not just support one bank.

So why are levels of collaboration not far greater? For FinTechs, it can be a struggle to negotiate the long procurement cycles of big banks. For banks, it's a challenge to successfully implement cutting-edge technology in large organizations based on IT from the 1970s. In our experience of working with both banks and FinTechs, these are commonly cited barriers to unleashing the potential of FinTech to transform banking businesses.

In 2016, the average return on equity (ROE) for the largest 200 global banks was just over 7.1%. To achieve an ROE of 12%, the top 200 global banks need to increase their revenues by 15% and reduce costs by 13.7%. Engaging with FinTechs, part of a broader banking ecosystem, will help banks drive down costs, innovate and enhance customer service.

As banks look to rebuild sustainable ROE, they must build better ecosystems. These will be founded on collaboration with FinTech firms, industry utilities and an array of other service providers – to help reduce structural costs, enable enhanced regulatory compliance and better serve customers.

¹ "EY FinTech Adoption Index," EY, 2017.

Unless banks and FinTech firms get better at working together, neither will reap the full benefits of innovation.

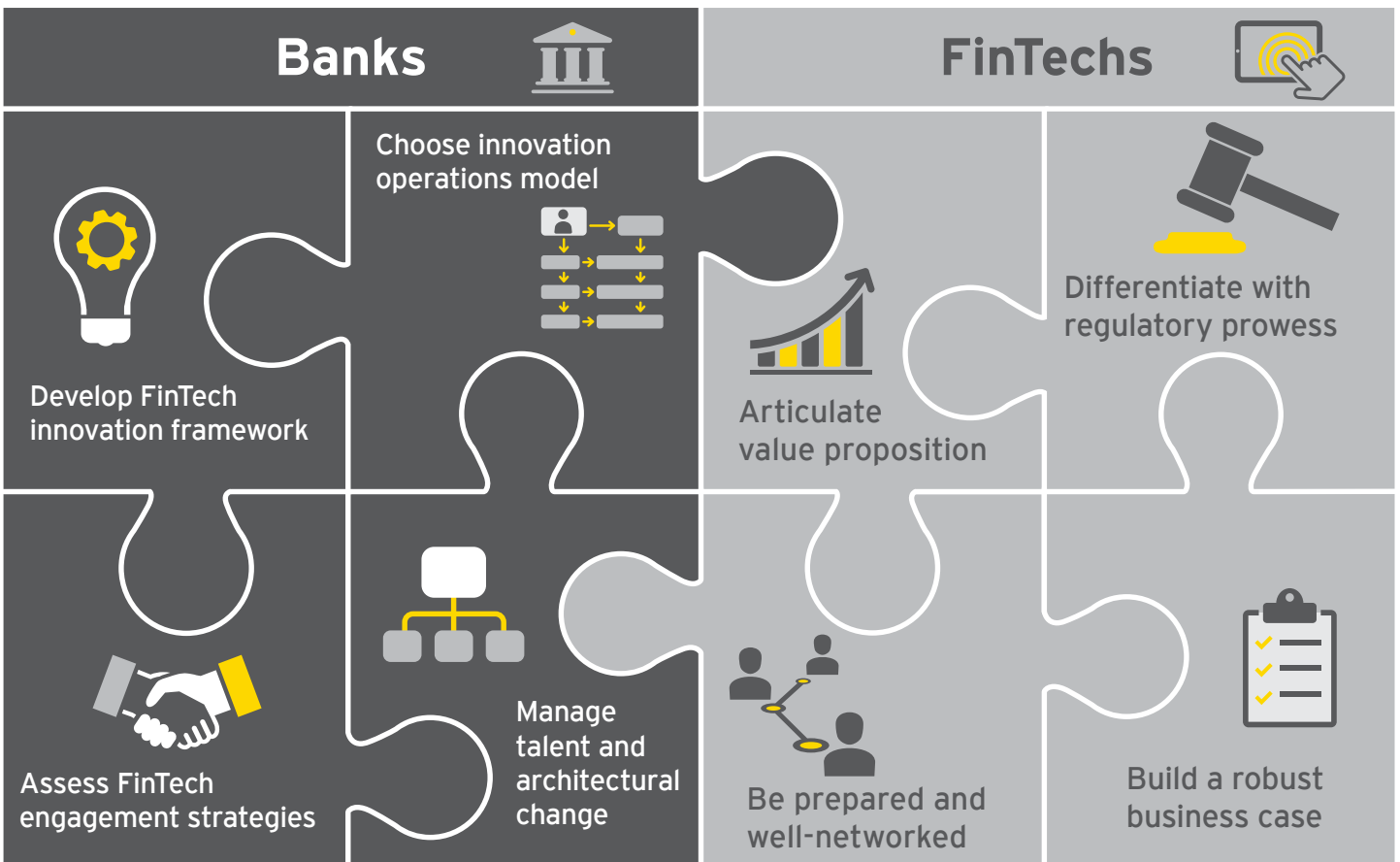
Banks are seeking ways to benefit from deploying FinTech across their organizations. Our analysis of data from 45 major banks over the last three years suggests that, globally, institutions remain principally focused on applications of FinTech in payments. However, they are increasingly looking to use FinTech across the entire value chain, from gamification of compliance training to surveillance software that can identify employees who pose the greatest organizational risk, and from using artificial intelligence to improve customer service to driving greater workforce productivity.

But picking the right FinTechs to collaborate with and successfully implementing new technologies remain challenging for banks that have weak innovation cultures. FinTechs, for their part, need to better articulate the clear benefits of their technology and work with banks to deliver change.

In this report, we explore how banks and FinTech firms can better collaborate to reap the benefits of new technology. The global FinTech industry is growing rapidly, driven by a powerful blend of innovative start-ups and major technology players. Banks that want to leverage this potential must act now to find ways to engage with these innovative organizations to achieve value-creating collaboration.

Unless banks and FinTech firms get better at working together, neither will reap the full benefits of innovation. They must partner, or they may perish.

Figure 2: The partnership imperatives and opportunities for banks and FinTechs



Partner or perish: actions for banks

Banks have many innovative ideas; the challenge is validating which to actively pursue and embedding the technology. The complexity, scale and siloed nature of banks mean they often struggle to do this effectively.



Today, large global banks are utilizing a multitude of approaches to engaging with FinTechs. They hope to cut their long-term costs while protecting their market share by introducing innovative banking products for their customers. But success is mixed.

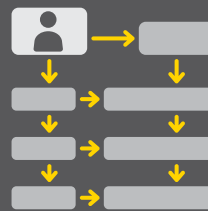
To collaborate with FinTechs and deliver truly transformational value, banks need to be clear about the innovation model, the scope and mandate for innovation, procurement and retained technology functions. Banks also need to determine how best to engage with FinTechs, given the contrasting sizes and cultures of their respective organizations. We see four steps to success for banks seeking to unleash the potential of FinTech in their organizations.

Develop a FinTech framework that rewards innovation



1

Choose an innovation operating model that connects new ideas to business needs while balancing innovation with risk



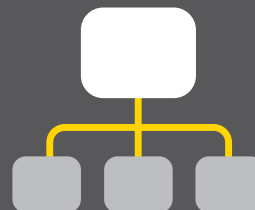
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Assess the pros and cons of your FinTech engagement strategies



3

Carefully manage talent and architectural change



4



1

Develop a FinTech framework that rewards innovation

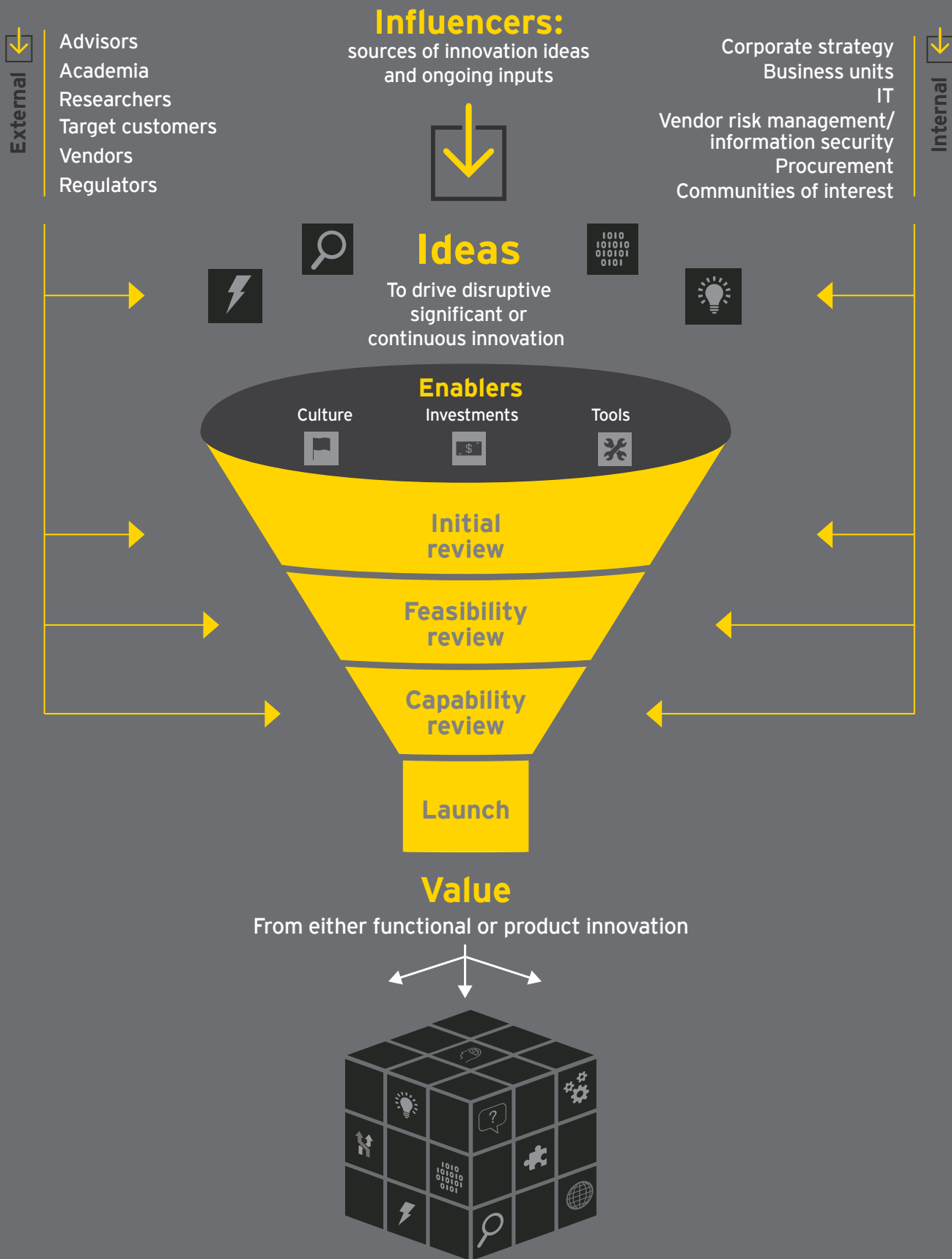
Many bank innovation opportunities address the challenge of structural costs, with benefits reaped over an extended time frame. By contrast, performance measurement and compensation cycles are usually short. In an uncertain economic environment, there is understandably some apprehension about accepting the additional risk of these investment costs. Banks need to resolve this inherent conflict.

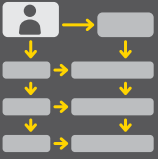
This means banks need to define guidelines within a FinTech strategy. The process must be driven from the top, encouraging innovation and building lessons learned into the process. An innovation adoption framework is needed to support innovation, with clear accountabilities, decision-making frameworks and criteria for success. New ideas should be encouraged and suggestions for innovation should be welcomed via internal social media. Hackathons are also a great way to encourage staff to develop and articulate innovative ideas.

We recommend that banks define their innovation framework and process clearly, then share relevant aspects with the firms they seek to engage with. This includes sources of external and internal influence, the end-to-end process, decision-makers and acceptance criteria, and the enablers to support the framework (see Figure 3).

The process must be driven from the top, encouraging innovation and building lessons learned into the process.

Figure 3: Innovation adoption framework





2

Choose an innovation operating model that connects new ideas to business needs

While many innovation operating models are in use today, banks typically employ one of three types: centralized, decentralized or hybrid.

In the centralized model, a chief innovation (or digital) officer oversees a central innovation team to develop business solutions. The model recognizes the specific need for innovation and exposes the organization to new ideas and concepts. It also can enable better coordination with the chief technology officer, and with procurement and vendor risk management activities. Yet there also may be a perception that the central team is too remote from the business units to fully understand their needs. When the centralized model works well, FinTechs can benefit from the support and structure it provides. Conversely, decision cycles may end up taking longer, with more time being spent before a business sponsor is found.

The decentralized model is more prevalent in small and regional banks. Each business unit runs its own governance processes, enabling those familiar with the business to identify real problems, and innovators with real solutions, far more quickly. The disadvantage is a duplication of effort, proliferation of local processes and lack of consistency. FinTechs that have strong relationships with banks may find that they engage more quickly with their business sponsor; however, without the support and direction of a central team, others may find it difficult to connect.

In our view, the hybrid model is the ideal solution. We think that a defined, distinct innovation team helps to set the right tone and message, and that innovation needs clear leadership to champion the cause – though, we recommend that the distance between pure innovators and business units needs to be compressed as much as possible. We also believe that transparency around the end-to-end innovation adoption process would be helpful. Few parties involved in the acquisition of innovation on the bank side profess to know how the end-to-end process works – so just imagine how confused FinTechs must be.

In our view, the hybrid model is the ideal solution.



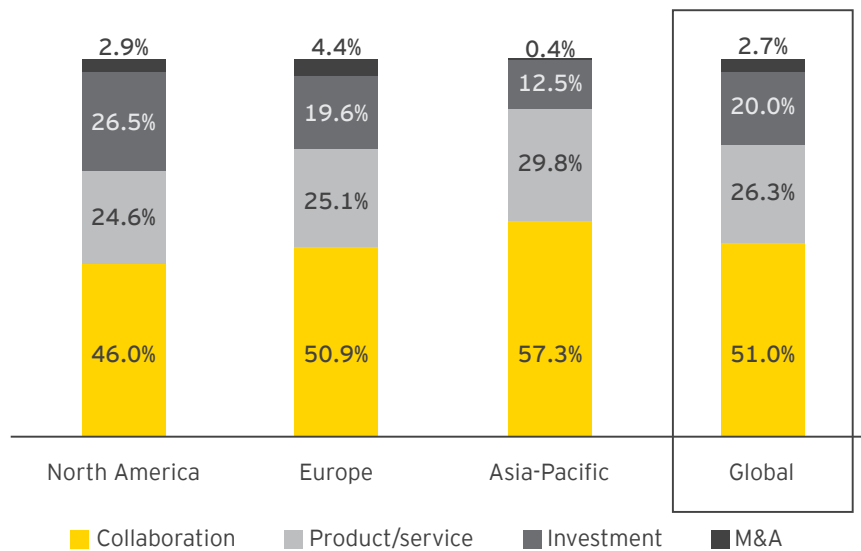
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Assess the pros and cons of your FinTech engagement strategies

Where banks turn to FinTechs to help drive innovation, our research shows that collaboration is the preferred engagement strategy (see Figure 4). A collaborative approach enables a network of banks to jointly develop new technology standards that they can adopt in the future.

Further, our analysis shows that large banks in the Asia-Pacific region are more focused than those in other regions on developing products in-house, particularly in the digital payments space to serve the underbanked customer segment. North American banks prefer investments over product development, and a number of major US banks have invested in FinTech start-ups. European banks have typically taken a balanced approach, and may be more willing to make mergers and acquisitions part of their FinTech strategy. Overall, only about one-quarter of the 45 global banks are extensively engaging with FinTechs by collaboration, developing their own FinTech products, investing in innovative firms or buying them.

Figure 4: Engagement model by region







Source: EY analysis

Additionally, banks are leading or participating in a number of accelerators, incubators and training programs to get early access to technology and talent without taking any significant stake in the FinTech companies. For FinTechs, such arrangements provide easy access to resources, data, funding, space and networking opportunities to test and showcase their prototypes.



There is no single answer as to how to engage FinTechs. However, banks look to FinTechs to drive innovation, and whatever route they choose to engage, all too often banks struggle to implement new and innovative technology successfully. The sooner innovation is embraced at all levels of the organization, the faster sustainable change will occur. Banks should carefully evaluate various engagement models and choose a mix that supports their innovation model and long-term growth strategy (see "Pros and cons of models of engagement with FinTech firms").

²EY analysis of FinTech activity of 45 large banks across three geographic regions (North America, Europe and Asia-Pacific, excluding Japan) since 2014.

Pros and cons of models of engagement with FinTech firms

		Pros	Cons
Investment 	<p>Banks invest their own capital in FinTech start-ups as:</p> <ul style="list-style-type: none"> ▶ Dedicated in-house venture capital or strategic investment arms ▶ Independent venture capital funds ▶ Investments on their own balance sheet 	<ul style="list-style-type: none"> ▶ Gains early access to innovative solutions ▶ Resolves lack of in-house talent and innovative culture ▶ Reduces time-to-market 	<ul style="list-style-type: none"> ▶ Right valuation can be challenging ▶ Monetization of investment ▶ Misuse and mishandling of data by third parties ▶ Not an exclusive relationship ▶ Data security and privacy
Collaboration 	<p>Banks enter into various types of arrangements with FinTech companies:</p> <ul style="list-style-type: none"> ▶ Utilizing products or platforms developed by FinTechs (e.g., a bank teaming up with a robo-advice FinTech to offer investment management services) ▶ Collaborating as a network to develop and test new technologies and solutions ▶ Referral arrangements, primarily in the peer-to-peer (P2P) lending space where a bank might refer a small business that falls outside the bank's risk appetite to a P2P FinTech ▶ Joint ventures or co-created services (e.g., a bank partnering with a FinTech firm to launch a digital marketplace) 	<ul style="list-style-type: none"> ▶ Reconnects with customers without significant time and resource investment ▶ Benefits cutting-edge projects such as blockchain ▶ Addresses lack of in-house talent and innovative culture 	<ul style="list-style-type: none"> ▶ Finding a compatible partner ▶ Monetization of partnership ▶ Data security and privacy ▶ Potential culture clashes ▶ Not always an exclusive relationship
In-house development of products 	<p>Banks are accelerating their in-house development of FinTech products and services. Historically, they have been slow to innovate new products, given the complexity of their businesses and strict regulatory and compliance environment in which they operate. Examples of innovation range from contactless payments and robo-advisors to a suite of e-banking products.</p>	<ul style="list-style-type: none"> ▶ Exclusivity ▶ Easily scalable ▶ Better control on technology, talent and resources 	<ul style="list-style-type: none"> ▶ Challenging given banks' traditional structures and legacy systems ▶ Expensive to develop, maintain technology and hire specialists ▶ Lack of in-house talent ▶ Increased time-to-market
M&A 	<p>Acquiring a FinTech company can increase a bank's digital footprint and short-cut the development of new technology. Our analysis suggests that this is typically banks' least preferred strategy, but we observe large global and regional banks taking stakes in online competitors.</p>	<ul style="list-style-type: none"> ▶ Rapid route into new markets ▶ Fast delivery/go-to-market ▶ Exclusivity ▶ New customers at low cost-opportunity to cross sell ▶ Market/product differentiation ▶ Access to talent and innovative culture 	<ul style="list-style-type: none"> ▶ Valuation can be difficult ▶ Difficult to integrate due to cultural differences, could lead to internal tensions ▶ Retention of talent ▶ Integrating new solutions into existing systems could accelerate costs

Pros and cons of models of engagement with FinTech firms (continued)

	Pros	Cons
Joint FinTech program 	<ul style="list-style-type: none"> ▶ Collaborative role with other banks alongside program participants (e.g., VCs, government agencies, program managers) ▶ Flexible to tailor staff's level of involvement according to resource capability ▶ Cost shared with other parties ▶ Mentorship, program sponsorship opportunities that provide enhanced FinTech network 	<ul style="list-style-type: none"> ▶ Limited branding opportunities (as these are shared with others) ▶ Potentially low financial ROI if small minority stakes are shared with others ▶ Involvement may be viewed as tokenistic
Lead FinTech program 	<ul style="list-style-type: none"> ▶ Ability to control program scope, set exclusive partnership terms and first-mover advantage on successful Ideas ▶ ROI potential from tailored solutions and first user of innovation solutions 	<ul style="list-style-type: none"> ▶ Requires dedicated team as interface between program managers and internal departments, and senior management requirements ▶ Budget required to support resourcing for each program cycle (e.g., participation accommodation, training logistics, program manager fees)



4

Carefully manage talent and architectural change

Transformational architectural change requires a multiyear commitment and potentially could diverge from a longer-term strategic vision. Whatever process is used to formulate the strategy, the fact is that the application, technical and data architecture of the future is likely to look very different than it does today. We expect leading organizations to seek internal simplification aggressively and to increase their use of external utilities, platforms and microservices where possible. We believe that a component-based architecture, resembling a set of interoperable building blocks, will drive innovation and next-generation efficiency. This will require the industry and its regulators to agree on standards and protocols. The industry is learning to collaborate better, but the speed at which standards are emerging could be quicker.

Moreover, the composition of talent will need to change. The stars of the future might well be internal entrepreneurs as opposed to those who excel at in-house development. This has implications for talent acquisition strategies at all levels of the organization.

New capabilities will be required in the future, and existing skillsets will need to be converted, in turn presenting development opportunities for people in the retained organization. Automation will free up human beings to perform more value-added tasks. We also expect to see some migration of people from banks to technology firms and service providers.

Many of the ideas and themes discussed could potentially be seen as threatening to the retained organization. Will software robots eliminate my role? Will my experience and skillset be relevant and cherished in the new world?

We believe those that will be successful will bring the retained organization along on the journey. Regular communication and participation in innovation will foster and drive collaboration. Silence and a “us vs. them” mentality will result in a demotivated workplace and will make it difficult to retain top talent.

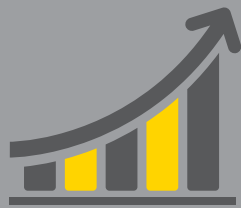
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Partner or perish: actions for FinTechs



In an industry where organizational structures are often complex and opaque, and where attention spans can be short, FinTechs need to know how to approach and navigate their way through banking organizations. To deliver value, they must focus on building credible business cases and pricing models, which can present some tough choices about what information to share with whom and when. The following areas are of key importance:

Articulate a value proposition



1

Differentiate yourself with regulatory prowess



2

Be prepared and well-networked



3

Avoid overreaching yourself by building a robust business case



4



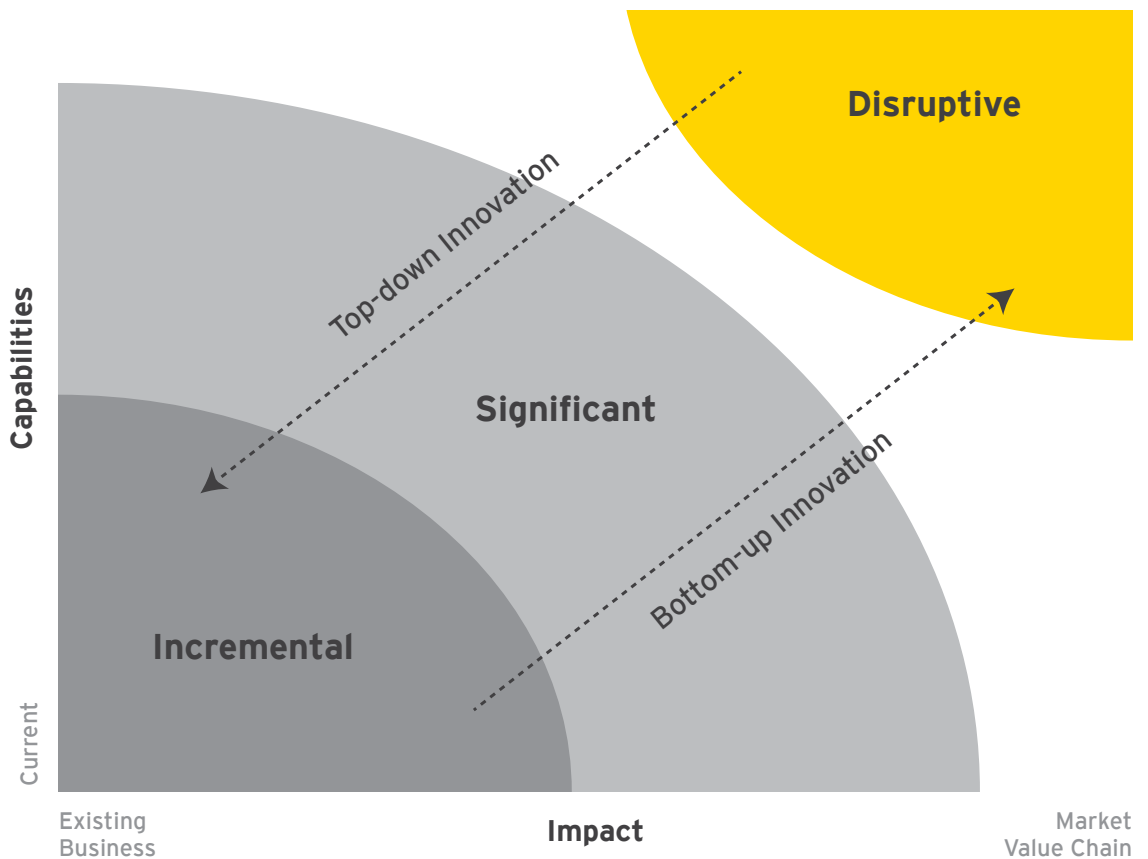
1

Articulate a value proposition

FinTechs need to determine what they are, what they intend to be and what problem they solve. Are they disruptive, incremental or significant? (See Figure 5.) Globally, there are more than 5,000 FinTech organizations – and those unable to articulate the problems and solutions have the potential to fail. There is a clear need to be distinct, over and above a memorable name and logo.

While banks are receptive to the various types of innovation, incremental or disruptive, FinTechs need to communicate and explain the value proposition in a language that the buyer understands.

Figure 5: Innovation approach framework





2

Differentiate yourself with regulatory prowess

Even though some FinTech firms may not be regulated, as part of the banking ecosystem, they must understand regulations and conduct business in accordance with local laws. The banking sector has significantly lost trust in the past few years, and we are now seeing widespread efforts to transform conduct and transparency. This is being driven by regulations and changes in the C-suite. Rebuilding trust is likely to take time – however, business models and ecosystems are rapidly evolving and will require collaboration to mitigate reputational risks.

It is of paramount importance that FinTech organizations maintain the highest standards of integrity. Competition is fierce because of the sheer numbers of firms and offerings, and there will be commercial pressures to seek shortcuts to gain competitive edge.

Proving the concept is the greatest hurdle. For regulatory reasons, banks are usually unwilling to share data with external firms without rigorous risk mitigation. Instead, proofs of concept tend to operate within bank-owned “sandboxes” – which is fine, unless the value proposition depends on data from multiple organizations.

When it comes to fostering collaboration between FinTechs and banks, regulators play an important role. This is because they set the framework, including limitations for services and products. When regulators demand innovation within financial markets, they also must provide an environment in which it can be fostered without fear.

Regulators are setting a positive example by introducing regulatory sandboxes, allowing financial organizations to test new ideas for a limited period with live consumers and loosened regulatory restrictions. This also offers the opportunity for collaboration between incumbent financial institutions and FinTechs.

Over time, regulation of FinTech firms will inevitably increase. While this is arguably necessary to protect the financial markets and the end users of finance, our hope is that the approach adopted will be pragmatic and proportionate to the risks involved.

FinTech firms and their solutions – embraced and adopted intelligently – offer banks a path back toward higher ROE.

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Spotlight: the importance of a supportive regulatory environment

In the UK, the Bank of England and the Financial Conduct Authority (FCA) have been strong supporters of FinTech. The UK has emerged as a global RegTech leader, hosting a range of start-ups. The FCA's Project Innovate supports new FinTechs, and the regulatory body is considering creating a robotic regulatory handbook, intended to accelerate the speed with which regulated entities can find answers to specific questions.

In Asia, while regulators are expressing enthusiasm for RegTech solutions, they also recognize the need to increase their awareness of technology to assess next-generation approaches and their regulatory implications. We see more progressive authorities holding regular industry dialogue with market participants (financial institutions, RegTechs, training academies and universities) to understand technology innovations and assess whether existing rules, policies and guidance are restricting innovation and the adoption of RegTech solutions. Meanwhile, to encourage RegTech development in Singapore, the Monetary Authority of Singapore has announced plans to make its data available through open-source application programming interface (API) architecture. This will increase efficiency in submitting data on applications and transactions for financial stability assessments.

The Australian Government has established the FinTech Advisory Group to complement the Innovation Collaboration Committee and promote its FinTech industry. As the advisory group identifies areas of potential future reform and specific FinTech priorities in implementing Government policies, it is paying special attention to RegTech.

In the US, however, there has been less proactive support to date, which is somewhat surprising given the maturity of the financial markets and the innovation culture on the West Coast. The Office of the Comptroller of the Currency (OCC) is looking at a framework to allow start-ups to submit new business ideas.



3

Be prepared and well-networked

Most major banks have dedicated innovation teams to introduce FinTech firms to business sponsors – with success depending heavily on internal party connections. Many banks also have a corporate venture vehicle that invests in FinTech firms as opposed to procuring solutions, but these banks shouldn't let their investments shape their judgment about which technologies are right for their own organization. One of the principles for successful innovation is the ability to fail fast – but the decision to discard a particular initiative may be harder when the same organization has a vested financial interest.

Other participants in the ecosystem also play a part. Consulting firms, system integrators and venture capitalists have relationships with banks and a commercial interest in brokering introductions. FinTechs need to understand who the preferred advisors are in the domain in which they are operating. Finally, there is nothing to stop FinTechs from approaching business sponsors directly. This tends to be easier for those that have former industry practitioners with strong relationships.

Once business sponsorship has been secured, the final hurdles to adoption typically involve the procurement, vendor risk management and information security functions. For younger organizations, encounters with these functions can be tricky. For example, the adoption process at each bank is different. Depending on the innovation and sourcing operation models, the timing process can vary widely. A further challenge is that the procurement and vendor risk management functions are still evolving with respect to FinTech onboarding. Some organizations are still applying a “one size fits all” approach and seem surprised when a start-up scores somewhat lower than a global system integrator.

While every bank's procurement process is different, questions and assurances follow common themes. Demonstrating a level of preparedness with regard to corporate history, funding, information security, data privacy, resiliency, scalability, architecture, processes and key people improves the perception of professionalism, and can help to mitigate banks' concerns about working with younger organizations.





4

Avoid overreaching yourself by building a robust business case

Building a credible business case is critical. In the current climate, ROI must be demonstrable, and payback periods need to be short. The most common reasons business cases fall short include unrealistic assumptions that lack credibility; underestimates of integration costs – especially to legacy architectures; failure to recognize the timing of benefits and supporting evidence relating to risk reduction; failure to consider what bank resources are needed; and underestimates of other dependencies, given the high volume of concurrent change within banks.

A critical component of the business case will be the pricing model. FinTech firms need to be crystal clear about their pricing strategy, which needs to reflect the value to both parties. Another common concern is the protection of intellectual property (IP). In many instances, ideas have been shared in confidence with banks, only for their in-house IT functions to build something comparable. FinTech firms have to strike a fine balance between sharing and protecting. Clearly, for a value proposition to be compelling, the core concept needs to be explained and justified.

While steps can be taken to protect IP through nondisclosure agreements, gaining recourse may prove challenging in practice. Therefore, it is vital to think hard about how much needs to be shared, and who really needs to see the recipe for the “secret sauce,” until the collaboration moves from point of concept to production.



Embedding FinTech in the banking ecosystem

The most successful banks will be those that improve agility and reduce cost by using collaboration to bring various components together and build the strongest ecosystem. Their retained organization will be stronger and leaner, augmented through external collaboration with FinTech firms, market utilities and managed service providers. The technology landscape will be modular, interoperable and ultimately simpler. The culture will be one of collaboration, not protectionism. Success for banks will be based on building a better ecosystem, not a bigger bank.

But to achieve this future state, banks will need to unleash the potential of FinTech in their own organizations (see Figure 6). Our experience working with FinTechs and banks suggests that both need to get better at working with each other to successfully drive innovation.

Figure 6: FinTech is a core part of the banking ecosystem



Further reading

EY regularly conducts research and publishes thought leadership on important banking market and industry trends, including the rise and role of FinTechs.

EY FinTech Adoption Index



FinTech firms have reached a tipping point and are poised for mainstream adoption. This report measures the level of traction FinTech is gaining in 20 markets around the world, looking not only at the overall rate of adoption, but also at which users are adopting which products, and the outlook for future adoption.

[Download the complete report](#) 

Global Consumer Banking Survey: Customer experience



Banks used to compete largely on price, product and scale of the branch network. But today, customer experience is the main competitive front. Thus, traditional banks must think and act like FinTechs - understanding and even emulating their approaches.

[Download the complete report](#) 

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ED None

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