Digital Transformation Risk Radar

Financial Institutions | May 2024

Digital Transformation

Overview of trends and recent developments

Digitalization and fintech are transforming business models, this trend having accelerated in recent years as is shown by the arrival of generative artificial intelligence. At the same time, the importance of operational risk and resilience has grown together with regulators' focus on it.

- Financial institutions are now operating in a world where customers increasingly wish to interact through social media, mobile apps and online platforms, while potentially having the ability to analyze vast quantities of data powered by the flexibility of IT solutions through the cloud. The business models of financial institutions are changing: How services are delivered, the ways in which they earn revenue and the search for new ways to monetize value.
- In consequence, financial institutions are engaged in digital transformation journeys abundant with opportunity and risk (especially for legacy businesses) or are entering into markets with unfamiliar regulatory rules in the case of new fintechs and technology businesses). Laws and regulations are lagging behind technological progress, but the pace of change is fast. Regulators' expectations around the need for resilient systems and controls in the face of new technological risk are increasing, as is their appetite for enforcement action.
- Technology in financial services is no longer limited to fintechs, but its adoption is a vital part of every financial institution's business model in order to react to disruptive competitors, meet higher customer expectations (over accessibility, functionality and ease of use) and to reduce costs improving operational efficiency. With the effects of higher interest rates being felt in the economy, productivity growth limited and other services becoming commoditized and so less profitable, financial institutions are looking to technology to provide new ways to offer value to customers and earn revenue.
- General AI has the potential to revolutionize financial services. It can automate complex decision-making processes, enhance risk management, and personalize customer experiences. By learning from vast amounts of data, AI predicts market trends, detects fraud, and could provide tailored financial advice. However, it also raises challenges around data privacy, security, and ethical use of AI. Therefore, a balanced approach is needed to harness the benefits of AI while mitigating potential risks.
- Regulators are supportive of fintech when evaluating new technologies, however, they are increasingly concerned with governance, transparency, accountability and where technology, such as artificial intelligence, does not perform as expected or fulfil legal requirements (e.g., not to discriminate). Similarly, regulators are concerned with the potential for financial crime and consumer protection — money laundering and high-risk investments with cryptoassets being a particular focus — and the risk posed to financial stability through overreliance on cloud services or by under-regulated, less resilient, tech companies on which financial institutions depend. Cyber security is a growing concern not only in respect of financial institutions themselves, but as regards third and fourth party vulnerabilities.

Digital Transformation

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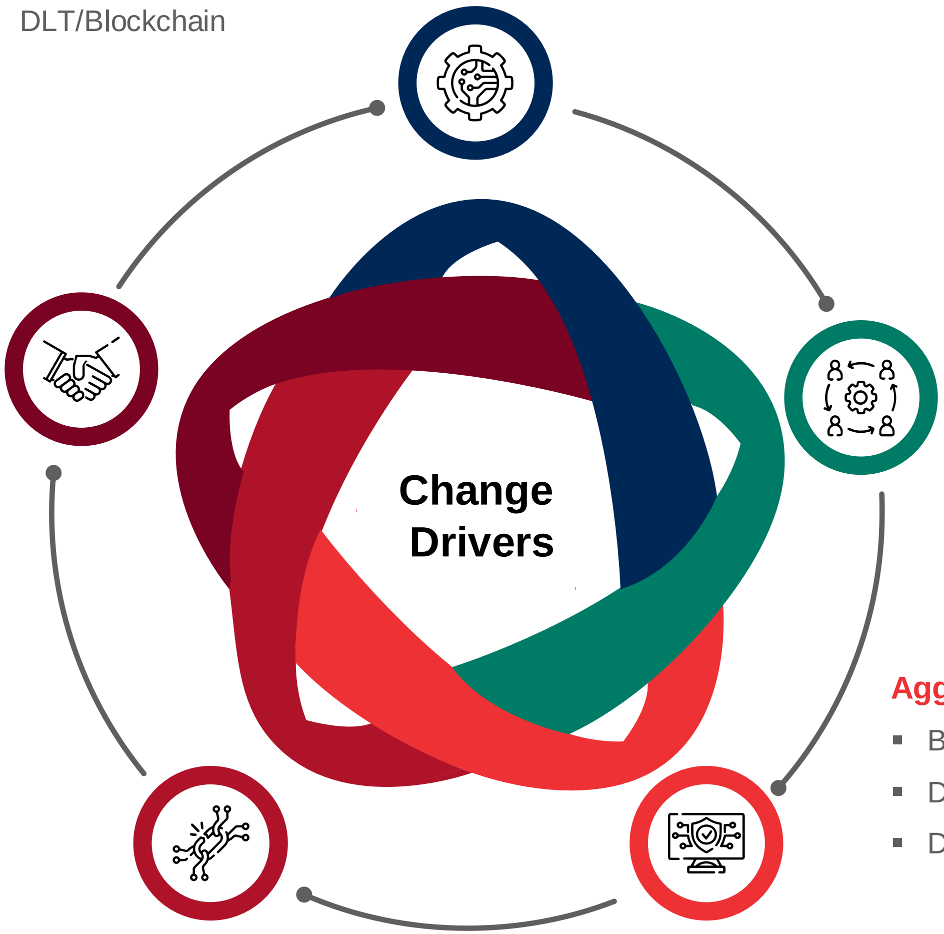
- DLT/Blockchain



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Digital Transformation

Drivers of change and risk

Innovative Technologies

Businesses are at different stages of the digital transformation life cycle. Technology barriers are disintegrating, connectivity between AI/robotics, connected devices, blockchain machine learning, big data, virtual and augmented reality is accelerating. Organizations must bridge the gap between the reality of legacy processes/systems and digital aspirations.

Workforce Redesign

Whether it's crowd working, employee sharing, fixed-term staffing or other such arrangements, creating a fit-for-purpose skilled workforce while protecting business interests requires a solution that incorporates often multi-jurisdictional advice across many areas including employment, tax and protection of confidential information/trade secrets.

Aggregated Data

Data is the currency of the digital economy and increasingly a key asset driving strategy. Data-driven business models give rise to a variety of novel legal issues which cut across compliance, data privacy, cybersecurity to antitrust, transfer pricing, VAT, tax planning, blockchain and more.

Regulation and Regulatory Relationships

Laws and regulations lag behind technological progress. Given the evolving regulatory landscape, being at the forefront of changes is critical. Companies increasingly seek help to look around corners and predict the future course of regulation to help them manage existing and emerging risks.

Transactions

Digitalization and the rate of technological change is driving cross-sector consolidation as businesses strive to acquire technologies, build in-house capabilities, diversify beyond their core businesses and build economies of scale. Business transformation whether through investments, partnerships, new business models or entering new markets may require a sophisticated approach to managing risk and M&A where legal counsel is invaluable.

About Digital Transformation in Financial Institutions

Digitalization is accelerating. With so much business now conducted virtually and attitudes transformed, digital technology which has been under development is now seeing its potential realized. It is reducing costs providing the opportunity to improve profitability, but requires investment that needs to be funded. We are seeing financial institutions with start-ups & market disruptors, innovation to core business processes, but also increasing regulatory risk awareness, e.g., over transparency, privacy and data security issues.

- Increased awareness and adoption of virtual banking. These benefit from cost efficiencies, providing significantly higher rates of return than traditional banks.
- Acceleration of remote delivery of financial services and their disintermediation with increasing modularity of financial services provision.
- Growing importance of operational risk and resilience, for example, in case of cyber-attack with financial institutions dependent on cloud and other new technologies while holding data of great interest to hackers.
- Banks are finding additional ways to partner with fintechs as more incumbents look to enter into the digital lending space. Technology is also leading to market consolidation as weaker firms seek to save costs and benefit from scale.
- The adoption of smart tech requires the licensing of (and or protection) of IP rights and new contracts fit for purpose. Moreover, workforces must adapt to the new environment with re-skilling and new talent recruited.

Innovative Technologies

Risk profile

Recent trends and developments

- Technology in financial services is no longer limited to fintechs, but its adoption is a vital part of every financial institution's business model in order to react to disruptive competitors, meet higher customer expectations and reduce costs.
- Cloud service providers — the on-demand availability of computer system resources — which usually sit outside the regulatory perimeter, are fast becoming part of the financial infrastructure. This is because financial institutions are progressively getting more dependent on cloud computing due to economies of scale, flexibility, operational efficiencies and cost effectiveness..

Risk Rating: Moderate

Associated risks

Artificial Intelligence and Machine Learning

Both AI and ML are increasing in use across a range of applications, for example, to assess credit quality, to price and market insurance contracts and to automate client interactions commonly with chatbots. The advent of generative AI has raised their profile even further. Both require proper management of their inherent risks — such as ethics, bias (e.g., when underwriting insurance and assessing credit) or accentuating market volatility in trading (e.g., herd behaviours) — through proper governance, auditability, "explainability" and accountability of their users. Regulation is increasing in this area, especially in the European Union.

Blockchain

Distributed ledger technology is versatile and has enormous potential but it is still in its infancy for example, tokenisation of funds and securities. Risks include the absence of concrete blockchain standards, limited inter-operability between platforms, an uncertain interface with legacy systems, exposure to cyber risks through shared infrastructure and an uncertain, evolving regulatory structure although this is improving. There is also uncertainty over the legal framework when a transaction goes wrong or disputes over property rights arise.

Cloud Services

Cloud presents challenges around data protection, banking secrecy, outages, security issues plus cyber-attack and concentration risk. There are potential systematic risks because large cloud providers could become a single point of failure when so many institutions rely on them. The fact that cloud providers are unregulated (although this is changing) and often sit in third counties raises further regulatory issues with supervisors requiring access and audit rights, augmenting the legal and regulatory tensions between all those involved. Increasingly, data localization is restricting the ease by which data may be transferred cross-border, thereby raising costs and, counter-intuitively, impeding regulatory oversight.

Baker McKenzie Solutions – Key issues we advise on

- Cloud
- 5G
- AI & ML
- D2C Business Models
- Evolving/Increasing Regulation of Smart Tech
- Contracting for New and Improving Tech
- IP Protection for Smart Tech
- Tech Trade Wars
- External Tech Investments/Financing
- Blockchain and Cryptocurrency Disputes
- Automated DR
- Smart Contracting
- ESG data
- Robotics

Workforce Redesign

Risk profile

Recent trends and developments

- Leadership in financial services organizations must not only implement technological changes that are shaping the future workplace, but also keep the customer experience, core technology, cognitive automation solutions, and emerging forces like blockchain top of mind.
- Businesses will need to understand how they can organize and operate digitally, hiring new talent and managers who are flexible, open to change, and comfortable with digitization. In addition, they will need to plan and implement careful reskilling and restructuring programs as they adapt to new technologies.

Risk Rating: Moderate

Associated risks

Virtual Workforce

Financial institutions and their workforces are taking advantage of changes in work culture and technology. There are, however, a wide variety of legal issues to navigate when managing remote working, including employment, benefits, share-based awards, immigration, corporate and employment tax, general corporate matters, trade secrets and data privacy. Moreover, financial institutions are learning how best to manage the regulatory concerns over conduct supervision especially for customer or market facing roles.

Contracting for and Protecting New Technology

The adoption of smart technologies invariably involves the acquisition of goods and/or services, and/or the licensing of intellectual property (IP) rights. For example, through Services and License Agreements for software or other IP which the business needs to use for or following its digital transformation. Businesses need the managerial and legal knowledge to manage the risks around technology, when acquiring, compliantly using (without infringement), and where they create IP effectively protecting valuable commercial assets of the business. This may require upskilling, recruitment and, of course, external legal advice.

Technology and Talent Management

The impact of digital transformation means that businesses in the sector must ensure that their workforce adapts to the market new environment re-skilling existing employees and recruiting new talent. Financial institutions need to recruit more digitally and IT trained staff (e.g., in AI) and in doing so they have to compete against a range of businesses, including technology companies and fintechs to secure and keep the best talent. Additionally, existing staff must be adaptable and ready upskill to work with new technologies.

Baker McKenzie Solutions – Key issues we advise on

- Transforming the Traditional Employment Model (e.g.; New Staffing Models)
- Remote Working (e.g.; Employment Regulatory Issues, Data Privacy, Trade Secrets, Tax, Real Estate)
- Digital Progress and its Impact on the Workforce (e.g.; Rise of Automation, Employee Surveillance)
- Managing Business Change and Disruption e.g., post-transaction integration and outsourcing

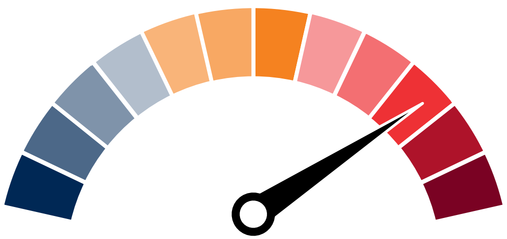
Aggregated Data

Risk profile

Recent trends and developments

- More and more types of data are being collected, including social media and other third-party data. Analyzing this "big data" is more efficient as new technologies allow its interrogation and analysis using algorithms and AI tools (including now generative AI) to design more targeted products and to develop new user cases. Mastering unstructured data offers further opportunities.
- Open Banking involves banks, at customer request, sharing data with third party providers, such as tech platforms, to allow them to offer services (like payments) directly to consumers. Extending this concept to other financial services e.g., pensions and mortgages is likely in the next few years.

Risk Rating: High



Associated risks

Big Data

Big data allows more efficient data analysis and the leveraging of the vast quantities of information available nowadays to optimize decision-making. It is an essential requirement for artificial intelligence. The insurance sector with its need to evaluate risk and calculate premium is well known for its use of big data, as are fund managers seeking to identify optimum investment strategies. With big data come risks, for example, the need to keep data secure against cyber-attack and in the case of personal data, compliance with data protection laws, where the potential for significant fines has grown in recent years. But there are also privacy and ethical issues over the use of this data including inappropriate profiling.

Data Ownership and Sharing

With the value of data going up, businesses want to control data. Unsurprisingly, access to data, its use and its free flow between systems, parties and jurisdictions are hot topics across industries, with not all governments supportive given sovereignty, competition and consumer protection concerns. Often this is a grey area with legal and reputational risk. New legislation in the EU, however, seeks to clarify who can create value from data and establishes a framework for access to and use of customer data in financial services; subject of course to conditions. It will also facilitate businesses' use of cloud and edge services.

Data Privacy and Protection

Data privacy and security laws, which restrict how businesses collect, use, share, store, and disclose data, are heavily regulated in many countries around the world. And yet, data privacy and security regulation is still very much a moving target with many countries introducing comprehensive regulation and other countries with established regimes overhauling them to reflect the reality of the digital world. Financial institutions must reconcile their obligations under e.g., the GDPR with other sector specific regulations or face large fines.

Baker McKenzie Solutions – Key issues we advise on

- Data Privacy & Security Regulation and Enforcement
- Integrated Global Cyber and Data Security Response
- Information Governance
- Data Monetization
- Data Sharing/Open Data
- Ethics and Trust
- Data Centers/Data Infrastructure
- Data as a Competitive Advantage
- Data in Deals
- Data Disputes
- Generative AI

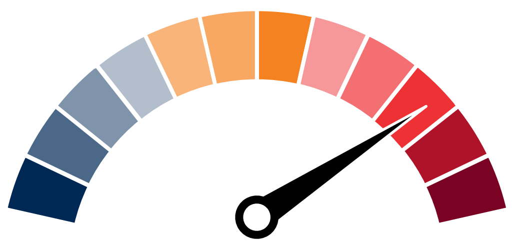
Regulation and Regulator Relationships

Risk profile

Recent trends and developments

- Digitization is already shaping the future regulatory environment in which financial institutions operate. It has increased regulators' expectations around the need for resilient systems and controls in the face of new operational and technological risk as well as financial crime; institutions face significant enforcement and litigation risk.
- Innovative use of technology and data is improving scrutiny of markets by regulators, so-called SupTech. Examples are finding the needle of market abuse in the haystack of transaction data by use of algorithms, mapping access to cash against consumer vulnerability, scraping the web for poor advertising or more quickly identifying red flags around potential wrongdoing

Risk Rating: High



Associated risks

Cryptoassets

The adoption of crypto as an asset class continues unabated despite high-profile failures of crypto exchanges, with markets having now recovered. For financial institutions, involvement with crypto has meant significant risks ranging from limited governance and transparency in these markets, and exposure to financial crime, to the challenge of investor protection and crucially, potential reputational damage. Governments have now largely brought the market within AML & CFT regimes and are now bringing crypto more fully within financial regulation and supervision (e.g., the EU's MiCAR in 2024). Greater regulatory certainty is increasing the appetite of traditional financial institutions to enter this market and use this technology.

Operational Risk

Operational risk and resilience have risen up the list of regulatory priorities in recent years. This can be linked to increasing levels of digitization and outsourcing in financial services. As the way in which services are provided is changing, new vulnerabilities are constantly emerging and, of most concern, incidences of cyberattacks are growing. This requires continual and expensive investment in IT, including systems and processes with informed oversight of outsourced services. Business continuity is a necessity.

Cybersecurity

Increasing digitalization and heightened geopolitical tensions mean that the risk of a cyberattack with systemic consequences has risen. The financial sector is particularly exposed due to the large amounts of sensitive data and transactions it handles. According to the IMF, the sector has suffered more than 20,000 cyberattacks, giving rise to USD 12 billion in losses over a 20-year period. That leaves aside regulatory penalties. A further risk factor is the increasing reliance of financial service providers on third-party IT services providers – which is further accentuated by the adoption of artificial intelligence products.

Baker McKenzie Solutions – Key issues we advise on

- Integrated Global Cyber and Data Security Response
- Evolving Regulatory Landscape for Transactions, Data and Smart Tech
- Forming and Maintaining Strong Regulator Relationships
- Understanding the New Digital Regulators
- Public Policy Work
- Cross-Border Compliance & Investigation Capabilities
- Blockchain and Cross-Border Trade
- Governance, systems and controls
- Operational risk and resilience

Transactions

Risk Profile

Recent trends and developments

- 2023 was a difficult year for fintechs to raise funding with their valuations negatively impacted due to high inflation and interest rates. The number of transactions was at its lowest for several years.
- 2024 may see an increase in private equity funding and buyers focusing on strategic transactions that add synergistic value to their portfolios.
- Expect to see robust M&A in business to business (B2B) payments, consolidation in embedded finance and banking-as-a-service.
- In the insurance subsector, traditional insurers are looking for acquisitions with a view to facilitating digitalisation, improving customer offerings, while aiming to reduce costs.

Risk Rating: Moderate to High

Associated risks

Joint Ventures/Partnerships

Fintech businesses are disrupting business models, but legacy financial institutions are partnering with them to compete through gaining access to their technology. This often takes the form of a joint venture, a separately incorporated and controlled company. Legally, such carve-out arrangements can be complex with respect to the transfer of assets (including IP rights) and liabilities. Where parts of existing businesses are transferred this may also affect employee rights. Additionally, there can be issues around regulatory supervision, including capital adequacy, and where a partnership is contractual in nature, it could be treated as outsourcing requiring adherence to further rules and guidance.

Fintech Acquisitions/M&A

Appropriate and adequate due diligence is essential when acquiring a Fintech. Many targets grow rapidly over a few years leading to many potential legal and compliance issues that need extensive due diligence with the risks accentuated in the regulatory space (e.g., contracts may not have properly been executed or IP rights protected). Moreover, operations may have been structured to fall outside of regulation – perhaps as a technical service or through outsourcing – but if operations are to be scaled up they'll likely receive greater scrutiny and issues may emerge. Such considerations are very important for cross border business where laws vary.

Financing Digital Businesses

Business contemplating scaling up will need additional resources. A start-up licensed business may benefit from light touch prudential requirements over capital reserves. To operate at scale regulators require more capital and liquidity to withstand shocks and protect customers. Moreover, where investment is sought from outside investors who exercise a degree of control over the business, regulatory approval may be needed, for example, that such persons are fit and proper. In cases of critical financial infrastructure, foreign ownership rules may apply.

Baker McKenzie Solutions – Key issues we advise on

- Digitalization/Rate of Technological Change Driving Cross-Sector Consolidation
- Foreign Investment/Geo-political/Regulatory Issues Impacting on Deals and Reorganizations
- Buying vs. Building, Investment Methods Broadening e.g., Corporate Venturing, Acquire
- Supply Chain Issues (e.g., Due Diligence, Reorganization)
- Buyers: Producers/Consumers (Different Perspectives/Strategies)

Digital Transformation in Financial Institutions

Resources

The Next Decade in Fintech series provides key resources exploring how technology will transform the financial sector.

Visit the Site

The Cloud Compliance Center aims to provide a snapshot of the legal and regulatory position of cloud in key jurisdictions of interest for financial institutions.

Visit the Resource

FInsight, Baker McKenzie's Global Financial Institutions Industry Podcast, provides recommendations and insights into sectoral developments and industry trends from Baker McKenzie's legal experts.

Available on: Soundcloud | Spotify
Apple Podcasts | Google Podcasts

The Artificial Intelligence Hub provides a suite of AI resources and insights, developed based on our analysis and market experience.

Visit the Resource

The Global Financial Institutions resource center curates relevant news, events, and publications for our FI clients.

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Baker McKenzie's Financial Services Global Regulatory (FSR) Guide has been updated for 2021 to incorporate changes across the globe in this rapidly evolving regulatory environment.

View the Online Guide | Download PDF

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