

Fintech M&A: From threat to opportunity

Fintech has evolved from being a disruptive threat to a major opportunity for financial institutions. The possibilities for dealmaking and M&A are almost limitless.



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Methodology

The research contained in this report was conducted by White & Case in Q3 2016. One-hundred and fifty senior executives at banks, asset management firms, insurers, fintech businesses and private equity/venture capital firms were interviewed, with 30 respondents for each of those classifications. Interviewees were also split evenly between those based in the U.S., Europe and Asia-Pacific (50 each). Fintech company respondents were split between early-stage startups (nine respondents) and mature companies with demonstrated revenues of US\$250 million or more (21 respondents). Respondents' job titles include Chief Executive Officer, Chief Financial Officer, Head of M&A, Managing Director, Managing Partner, Partner and equivalents. All interviews were conducted over the telephone. The survey included both qualitative and quantitative questions. The results are presented in their entirety and are anonymised.

The race to harness fintech's potential is driving dealmaking

Financial institutions are eager to harness the opportunities that fintech provides in the new digital age. Investment and M&A deals are increasingly at the forefront of fintech strategy

The financial services industry was never going to be left alone as the recent wave of new technology disrupted one industry after another. Yet while this could be predicted, the depth and breadth of change being brought about by financial technology—or “fintech”—promises to redefine and reshape the sector as a whole.

With this in mind, banks, insurers, asset managers and other financial institutions are becoming more proactive in their approach to fintech. In practice, this is leading to increased investment and M&A activity as financial institutions look to accelerate their fintech strategies. As our survey shows, this is not just about opening up new growth channels or products (although fintech does provide significant growth opportunities). It is also (and, arguably, more so) about using technology to create business platforms and market infrastructure which are faster, more efficient, robust and more secure than anything we could have imagined just a few years ago. And in order to keep pace with rapid technological advancement, financial institutions are increasingly turning to external investments and M&A deals rather than relying only on their own fintech development.

These M&A deals aren't just taking place in fintech's—and indeed, technology's—heartland of North America and in particular Silicon Valley. As fintech's importance grows, so does fintech deal activity across global markets. Indeed, as seen in our survey results, the explosive growth of the financial services sector across Asia, as well as the emergence of many fintech hotspots in Europe, are providing more and more fintech dealmaking opportunities around the world.

However, despite recent deal activity and an expected increase in volume and size of fintech deals, many of our survey respondents still have concerns. Most notably, worries about inflated deal values leading to a possible bubble; and concerns with performing satisfactory due diligence on digital assets linger on. On top of this, fintech's emergence has created a regulatory black hole as some fintech companies seek to take advantage of “regulatory arbitrage” while global authorities try to understand how existing obligations and upcoming legislation will apply to new technologies.

Even with this in mind, however, the future is bright for fintech dealmaking. Fintech will continue to drive the evolution of financial services, disrupting some sub-sectors, enabling new developments in others, and providing new and improved infrastructure for the digital age. As the market evolves, fintech M&A and investment will only grow.



How fintech deals are reshaping financial services

As fintech takes a prominent role in the financial services industry, major institutions are looking to capitalise on innovation by working with the most ambitious and brightest startups

In much the same way that digitalisation and the increasing use of smartphones have disrupted the transport and consumer sectors, with companies such as Uber and Airbnb demonstrating that technology can open up markets in a short period of time with little need for investment in physical assets, fintech has come to the fore in the finance industry.

Traditionally, the financial services sector has been dominated by large, entrenched institutions and characterised by high barriers to entry. However, the combination of new technology and the introduction of new payment services regulations across the globe (including, in Europe, the initial Payment Services Directive in 2009) started to entice non-financial services firms towards the lending market. From this, fintech entrepreneurs have seized the opportunities created by mobile technology to reach more customers with greater ease, less expense and in a more engaging way. According to data from KPMG and CB Insights, global investment in fintech in the first three quarters of 2016 was US\$18 billion, compared with US\$19.1 billion for the whole of 2015. On top of this, fintech inventions are also at the heart of reconfiguring financial market infrastructure.

Whether it be payment processing, lending or insurance, all aspects of financial services have been impacted. In the past 18 months, payment processing companies such as PayPal, Square



75%

growth of fintech investment in 2015. Source: Accenture and CB Insights



84%

growth in UK alternative finance sector in 2015. Source: Nesta, Cambridge University, KPMG

and Worldpay have secured multi-billion-dollar IPOs, valuing them at significant premiums.

Peer-to-peer lending and crowdfunding are also increasingly gaining traction. Figures from Nesta—an innovation charity—Cambridge University and KPMG meanwhile, show that in the UK alone the alternative finance sector, including P2P and crowdfunding, did £3.2 billion-worth of loans, investments and donations in 2015, 84 per cent more than 2014.

In insurance, price comparison websites have disintermediated the market, offering consumers greater choice, price transparency and speedier purchasing. Although this sub-sector has shown signs of maturing in the past 24 months, players such as Moneysupermarket.com, which has seen its share price grow more than three-fold in the past five years, have continued to expand. Further, wealth management is also seeing fintech-related disruption, with the proliferation of “robo-advisors” creeping into the industry. Indeed, the world’s largest private wealth manager, UBS, is launching its own robo-advisor with UBS SmartWealth. Across sectors, established financial services firms are clamouring to get involved.

Fitting in fintech

Rather than viewing fintechs as disruptive competitors, financial services companies are now looking for ways to collaborate with these businesses for mutual benefit.



Fintech entrepreneurs have seized the opportunities created by mobile technology to reach customers with greater ease, less expense and in a more engaging way

“Institutions accept that they need to reinvent the way they use and develop technology, and fintech providers recognise that payments, for example, is only a small part of what institutions do,” says Alastair Lukies, chairman of Innovate Finance, an independent not-for-profit membership organisation serving the global fintech community. “There is much bigger business to collaborate with.”

Another sign that the financial services sector now feels more comfortable with fintech is the fact that they have the confidence to identify where fintech can fit into their companies and make acquisitions accordingly.

Spanish bank BBVA, for example, has placed M&A at the centre of its digitalisation strategy and used

acquisitions to accelerate its digital banking development. BBVA deals include the US\$117 million purchase of Oregon-based digital banking pioneer Simple and a US\$67 million deal for a 29 per cent stake in online bank Atom.

Most financial services companies now recognise that fintech will be key to their future strategy, after initially taking a cautious approach and stepping back to observe the fintech sector establish itself. Indeed, nearly nine out of ten respondents to our survey see fintech as having a major part or leading role in their corporate strategy (Figure 2).

The hunger to acquire grown-up startups is rising, and there is a greater number of mature fintech companies in the market. According to Accenture and CB Insights in 2015, there were 94 fintech deals globally worth US\$50 million or more, a record high.

Mutual benefits

It is not just the case, however, of financial giants forcing their will onto smaller startups—the idea of collaboration is very much a two-way street. An analysis of fintech deal data by Accenture and CB Insights shows that investment into fintech firms wishing to collaborate with the industry increased by 138 per cent in 2015 and accounts for 44 per cent of all fintech investment, up from the 29 per cent recorded in 2014. Investment into fintech companies seeking to compete with the industry, by contrast, was only 23 per cent higher in 2015 than the previous year.

Investing in fintech through corporate venturing arms or bespoke fintech funds continues to be a valuable tool for exploring the market and buying in technology.

Much of BBVA's M&A activity, for example, has been directed through its corporate venturing arm, BBVA Investments. Elsewhere, Santander chairman, Ana Botin, announced in July 2016 that the bank would double its investment in Santander InnoVentures, its London-based fintech venture fund, to US\$200 million. The fund takes minority stakes in fintech startups with a view to incorporating new technology into Santander's banking operations. Milan-based Unicredit



has adopted a similar approach, committing US\$200 million to a fund managed by Anthemis Group. In China, meanwhile, the CCB Trust, a subsidiary of the China Construction Bank, was among the main backers of a US\$4.5 billion funding round in Ant Financial.

Investing in fintech through fund structures allows institutions to monitor developments in the market without having to commit to an acquisition of a technology that is promising but still needs to prove its relevance. For example, Brazilian bank Banco Votorantim partnered with Microsoft in October 2016 to invest in the tech giant's BR Startups fund, which has backed around 70 startups since its creation in 2014.

Multiple paths

For banks headquartered in the U.S. or with US subsidiaries, however, exploring the fintech space in this way is more complicated. The US Bank Holding Act and the Volcker Rule place restrictions on the size and the nature of equity investments that banks can make. These rules prohibit banks from holding more than 5 per cent of a non-bank subsidiary and restrict investments in covered funds, making it difficult to dip into fintech in this way.

"The rules on equity investments by banks are not intended to restrict



54%

respondents looking to collaborate with mature fintech firms in the next two years



70%

say fintech plays a major part in their corporate strategy

activity in fintech, but banks do have to take a legally robust position. Investing in fintech equity stakes is such a small part of what banks do that it can be difficult to justify all-out engagement with a regulator on this issue when it is not a primary focus," says a global bank executive.

Banks that do have to comply with the Volcker Rule and the US Bank Holding Act have looked at other ways to engage with fintech. Some have supported incubators and accelerators, providing mentoring, office space and other resources instead of equity investment.

"An incubator model is a good way to see what is going on and build relationships. An institution can hold a startup's hand through development and if a product gains traction, the bank will have a good understanding of how to fit the technology into its business," the executive says.

With so many approaches available, choosing which one is right for a given financial services business is very much a situation-dependent decision. "What we look to do is make a decision on whether to buy in a technology or build it up in-house," says Kaushalya Somasundaram, global head of fintech partnerships at HSBC. "There are advantages and disadvantages to either approach. Doing things in-house can take

Figure 1: In what ways are you looking to engage with fintech companies over the next 12 to 24 months? (Please select the most important)*

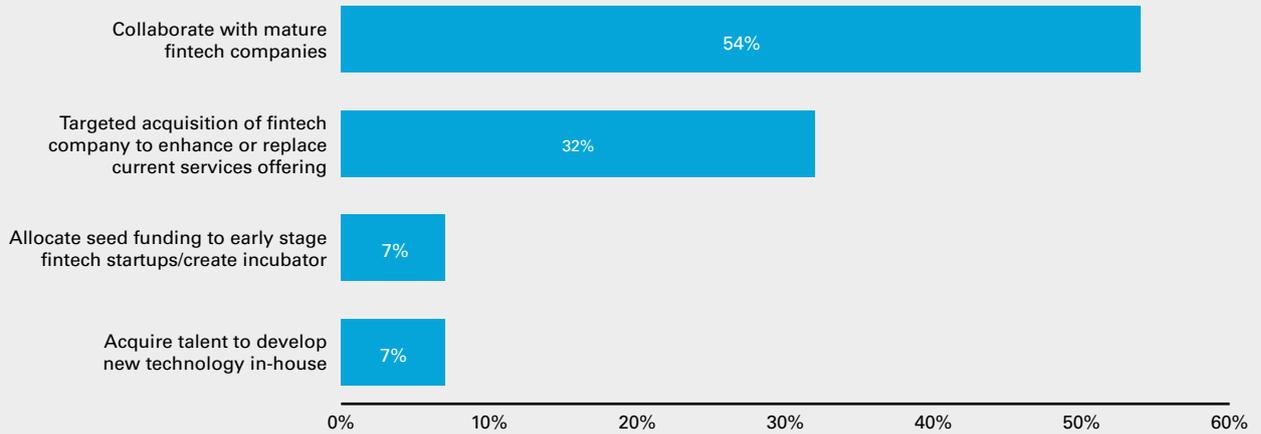


Figure 2: What role does fintech have in your corporate strategy?*

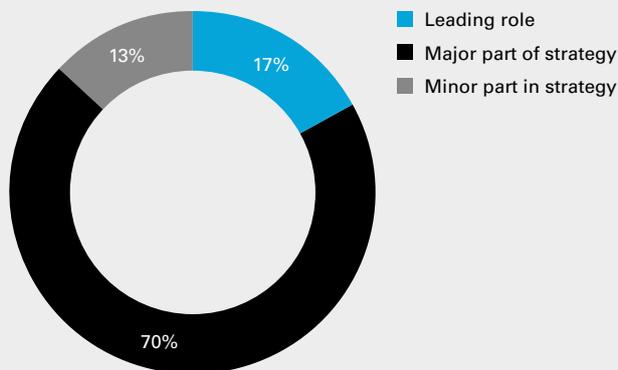


Figure 4: At which growth stage are you looking to acquire fintech companies?*

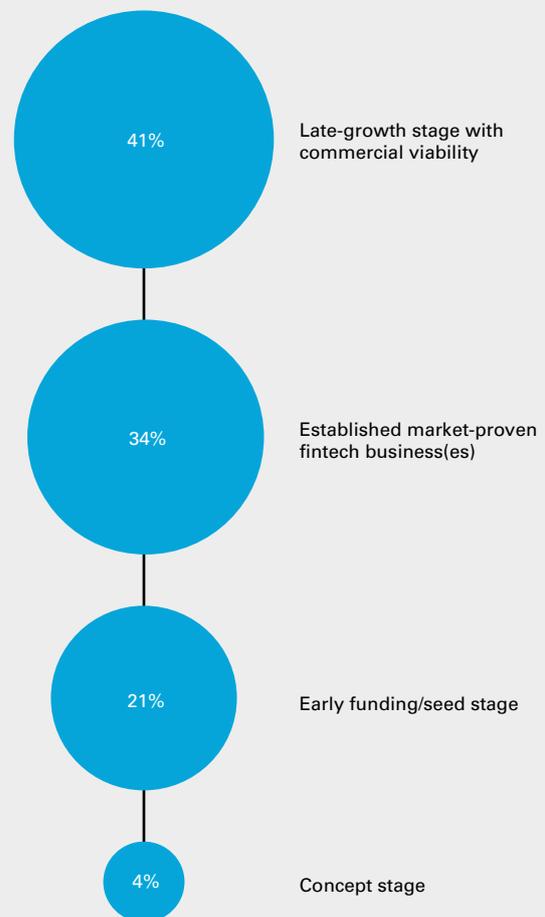
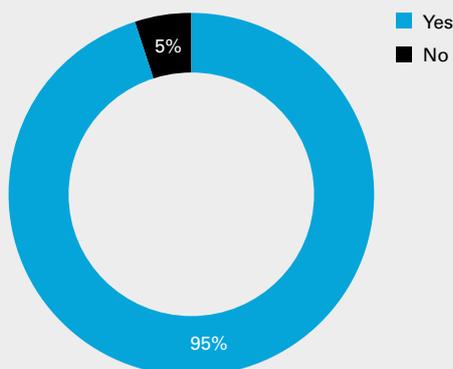


Figure 3: Do you expect to do a fintech deal or investment over the next 12 to 24 months?*



*Financial services respondents only.

longer and prove costly, but developing something in-house also means you are developing your own IP, which makes it harder to replicate and means you can tailor it to your own organisation's needs."

"The important thing to recognise is that there is no one way to address fintech," adds the global banking executive. "Institutions recognise that and are taking a multi-pronged approach by doing work in-house, forming partnerships, making acquisitions and supporting fintech funds."

Deal drivers

The combination of M&A deals, joint ventures and partnerships with fintech firms is helping established giants become more efficient and open, as well as creating new distribution channels and cutting down costs. J.P. Morgan, for example, has partnered with online lender On Deck, using its technology platform to process loan applications. Zopa and Metrobank have a similar deal, where Metrobank loans will be provided on Zopa's platform.

In both of these examples, banks have seen value in backing an existing digital platform to widen the distribution of their loans, reach new customers and cut the costs of processing loan applications by using digital infrastructure.

"Fintech is something that can liberate banks and financial institutions that, over the years, have had to spend more time and resources running their branch networks and large back offices. Fintech can help them get back to their core business as risk lenders and service providers," Lukies says.

Yet while the focus on fintech M&A is predominantly on generating growth, the emergence of new capabilities can also help larger financial institutions to navigate regulatory requirements. This is particularly salient when thinking about the European Payment Services Directive 2 (PSD2), which will become law in all EU Member States by January 2018 at the latest. PSD2, which will force banks to open up account data to trusted third parties and customers, could provide

the perfect reason for fintech and financial services firms to increase their collaboration and dealmaking. According to Accenture analysis, PSD2 and other regulatory changes could see UK banks losing up to 43 per cent of their payments-based revenues by 2020.

Growing up

A sign that the fintech market is maturing is that 95 per cent of respondents now expect to do



Investing in fintech through fund structures allows institutions to monitor developments in the market without having to commit to an acquisition of a technology that is promising but still needs to prove its relevance

Figure 5: What do you perceive as the biggest deal driver for fintech deals? (Please select the top 3, 1 = most important)

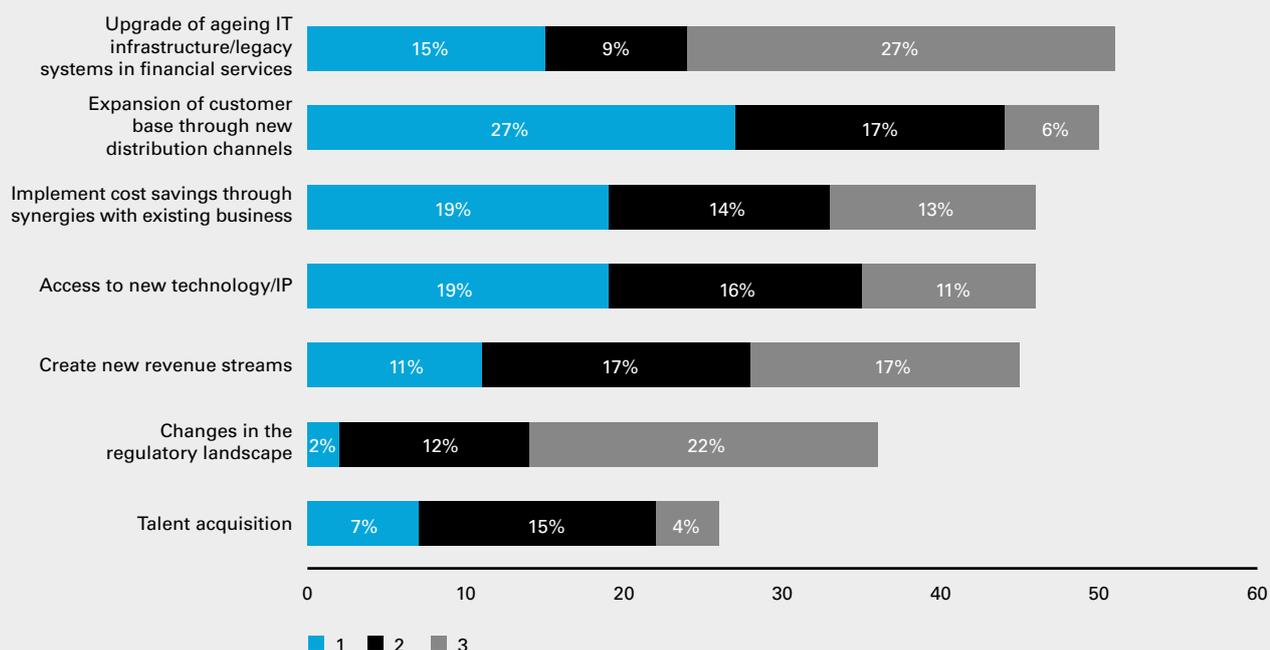


Figure 6: What type of transaction are you considering? (Please only select one) (Respondents expecting to do a fintech deal or investment over the next 12 to 24 months)

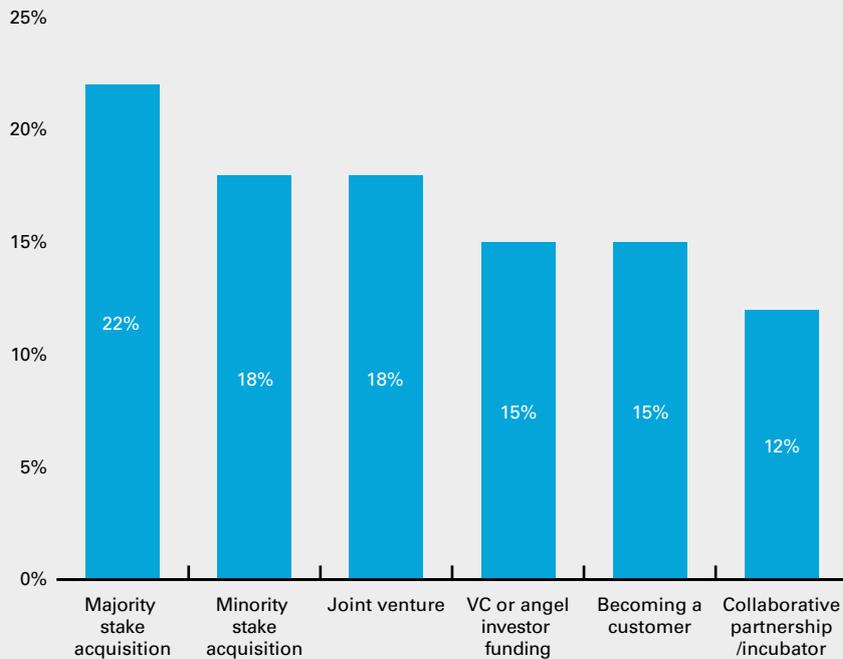
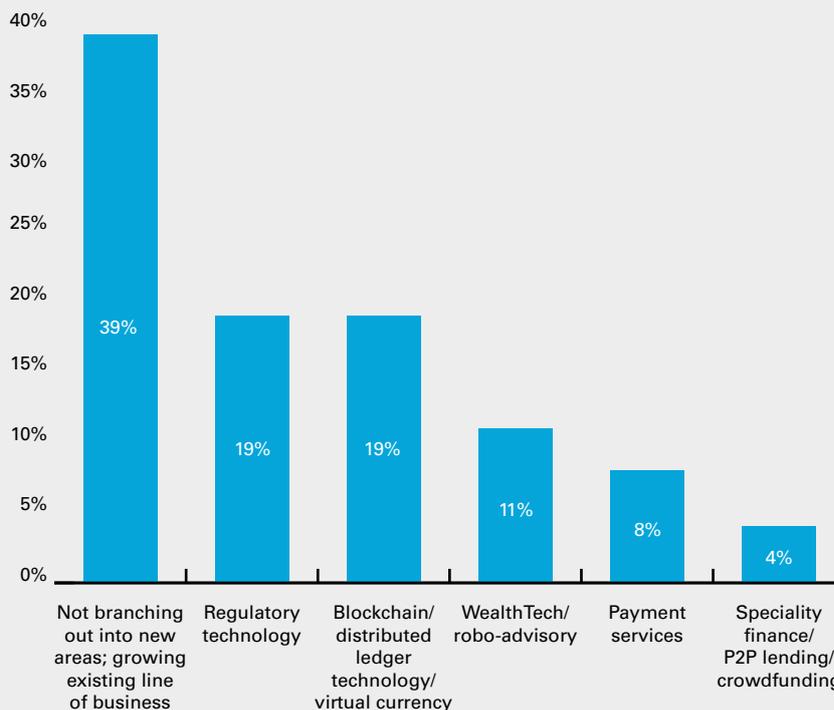


Figure 7: What type of fintech business are you looking to be involved in over the next 24 months that you are currently not engaging with? (Please select the most important)



a fintech deal or investment in the next 12 to 24 months—22 per cent expect to undertake a majority acquisition, just under a fifth (18 per cent) expect to be involved in a minority stake acquisition, and a further 18 per cent expect to be involved in a joint venture (Figure 6). As fintech continues to evolve, businesses are looking at opportunities to participate in the next wave of disruption.

There are new opportunities, for instance, to develop and use big data, insure-tech, blockchain and enterprise resource-planning technology in an operational rather than consumer-focused context. Well over a third of respondents (39 per cent) are not seeking to branch out and are instead focusing on existing business lines. For those looking into new areas, regulatory technology (19 per cent) and blockchain/distributed ledger technology (19 per cent) rank as the most popular (Figure 7).

Focusing on what you know chimes with the theme of keeping risks down and maximising speciality.

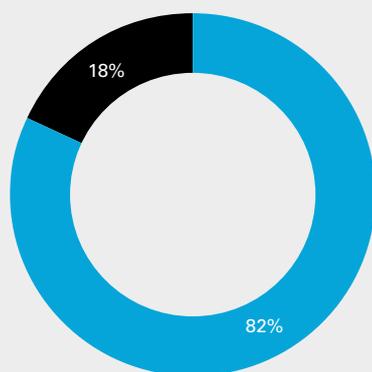
“Our prime area of focus is to concentrate on our existing investments and acquire along the same lines,” says a partner of a private equity firm with an interest in fintech. “We do not want to scatter our capital, as it would mean dealing with more risks at once. The plan is to focus on the current growing line



While the focus on fintech M&A is predominantly on generating growth, the emergence of new capabilities can also help larger financial institutions to navigate regulatory requirements



Figure 8: What level of integration do you intend to achieve with your next acquisition?



■ Full integration
 ■ No integration

of business so that we can make the expected returns from the same source. Diverting or having too much involvement would be risky.”

For larger financial services companies that already cover several areas, allowing subsidiaries some degree of autonomy regarding fintech can bring its own benefits. “Fintech is so broad and changing all the time, so we encourage each business line to engage with fintechs in their specific area, as they are the ones closest to the market,” says Somasundaram. “Once they have decided which fintech they want to work with and in what manner, we have a central team that engages with the fintech company, builds the relationship and coordinates the process.”

Putting the pieces together

Many financial services firms find it difficult to bridge the culture gap between old and new worlds. One reason for this is the cultural disparity between large financial services firms that are rigid but powerful and up-

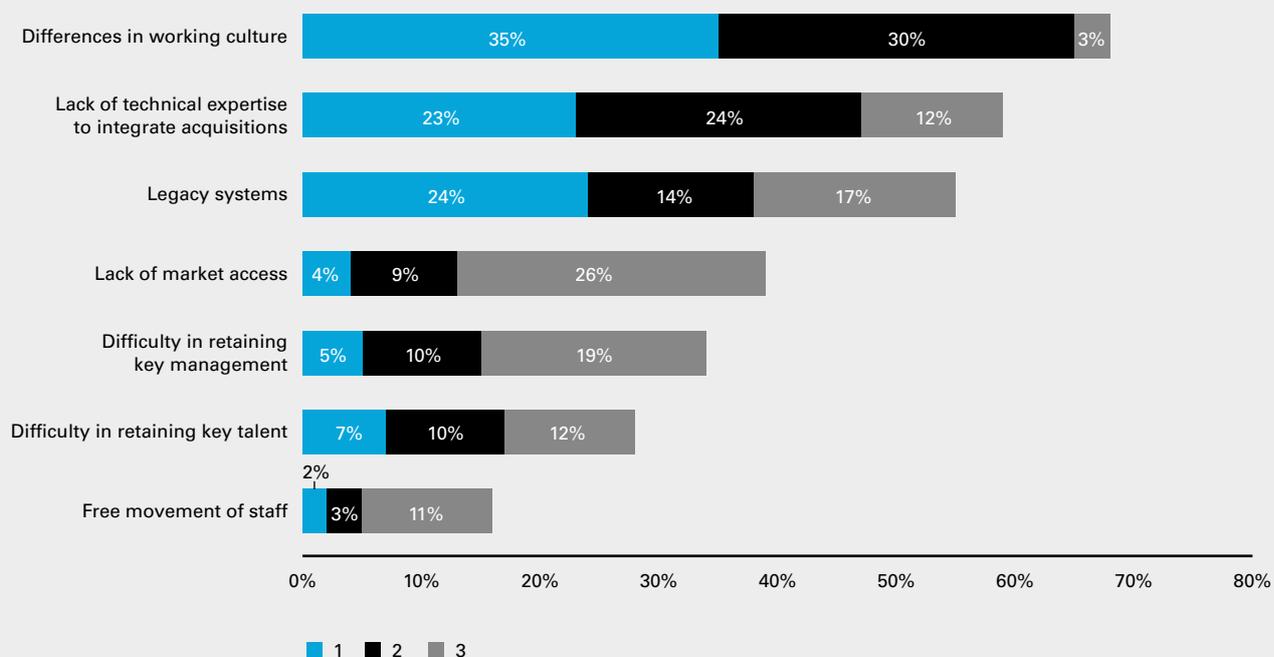
and-coming fintech startups that offer huge potential but lack the scale.

This brings up two issues. First, integrating fintech assets carries the risk of clashing cultures. Further, embedding new technologies and ways of working when large amounts have already been invested in legacy projects and infrastructure can also cause disharmony.

Culture clashes are a problem for startups in general. Indeed, while not in fintech, much of Tumblr’s disappointing performance since its acquisition by Yahoo has been attributed to a failed combination of the two companies’ sales teams. Fintech can be equally as fallable.

“Integrating a fintech business with a startup culture and willingness to take on risk and experiment often grates with that of a large financial institution that is focused on regulatory compliance and risk reduction. You also have one group used to launching new products and services, and another that has invested huge resources

Figure 9: What do you perceive as the biggest obstacle or challenge for fintech post-acquisition? (Please select the top 3, 1 = most important)



and time into building up existing infrastructure, and is reluctant to scrap that in favour of something new,” one fintech investor says.

Best practice for fintech integration is yet to emerge, as it is only recently that institutions have made such acquisitions. Many have invested but allowed fintech companies to continue operating independently for the time being. This is seen in HSBC’s initiative to house its 3,000-strong digital team in a separate building from its main office in order to foster a creative, startup mentality that won’t be suppressed by bureaucracy.

Indeed, financial services executives are clearly looking to bridge the perceived gap between institutions and fintech startups. In 2016’s MIT Sloan CIO Symposium, for example, Principal Financial Group CIO Gary Scholten explained how his company is digitally transforming by changing its approach, creating minimum viable products (a development technique of building a minimum



35%

see working culture differences as the biggest issue post-fintech acquisition



39%

respondents just focusing on existing business lines in fintech

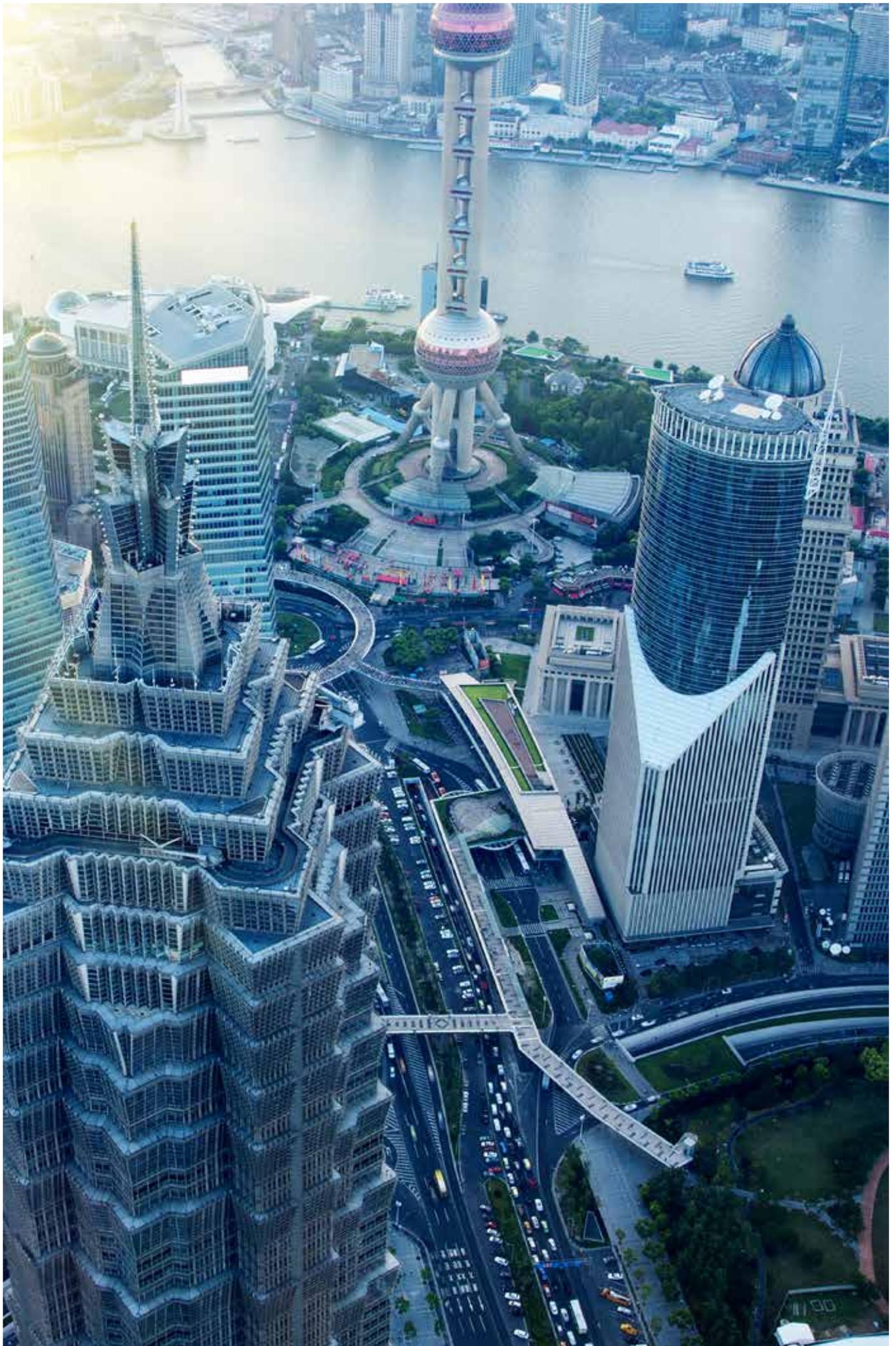
set of features on a product in order to gauge feedback from early adopters), adapting as new data surfaces and being more experimental. “To be successful in digital, you have to act like a startup,” he said.

However, for all the talk of allowing fintech to innovate and revolutionise, this can be extremely tough to do in practice. For one, the implementation of fintech, while streamlining businesses, could also threaten jobs. A Citigroup report from March 2016, for example, suggests that European and US banks will cut 1.7 million jobs in the next decade as fintech develops—and in a heavily regulated and unionised industry, this will not come without resistance.

Another potential issue for emerging firms trying to break barriers is gaining trust among traditional financial services consumers. A 2016 survey from CapGemini and LinkedIn found that fewer than one in four customers trust their fintech provider,

compared with more than a third for traditional financial companies.

“Fintech is still so young and new, and institutions are still trying to understand it and integrate it into their businesses,” says Graham Kirk, associate general counsel—group M&A at HSBC. “It will take time before fintech fully beds down into the structures of an institution. Just looking at the legal side, integrating fintech means that financial services companies now need to take a multi-disciplinary approach across their teams of corporate, commercial, tech, and IP in-house lawyers.”



Global trends in fintech dealmaking

North America dominates the fintech landscape, but competition from Asia and Europe is rising

Silicon Valley and North America have been key to fuelling the growth of fintech since its infancy. In each of the past six years, Accenture and CB Insights figures show the region accounting for the lion's share of fintech investment. It represents more than half of the US\$22 billion invested globally in fintech last year. And the pace doesn't look like it will let up—37 per cent of respondents expect North America to be the busiest region for fintech dealmaking over the next one to two years (Figure 10).

The US market has shown itself to be one of the most mature, with companies such as PayPal, Square and First Data all securing US\$1 billion-plus valuations following IPOs in the U.S. in 2015. Tech giants such as Google, Apple and Facebook continue to operate on the fringes of financial services, too, building new payment-processing technologies on their platforms, while North American banks are looking to invest in fintech in order to defend market share and reduce costs. Little wonder, then, that Silicon Valley/San Francisco is the clear favourite for the next 12 to 24 months as a fintech hub.

China's fintech potential

While North America is expected to continue holding its position as the dominant region for fintech investment, the rest of the world is catching up.

Accenture and CB Insights data show that although North American fintech investment grew 44 per cent to US\$14.8 billion in 2015, European fintech investment climbed by

Figure 10: In which region do you expect dealmaking to be the busiest over the next 12 to 24 months? (Please select only one)

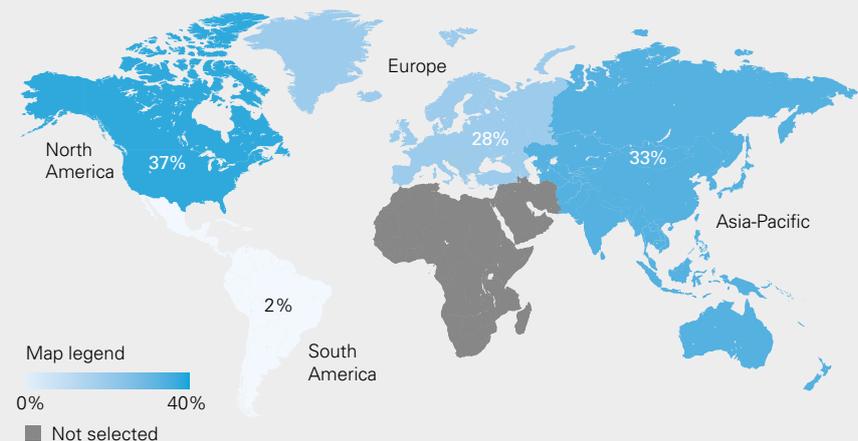
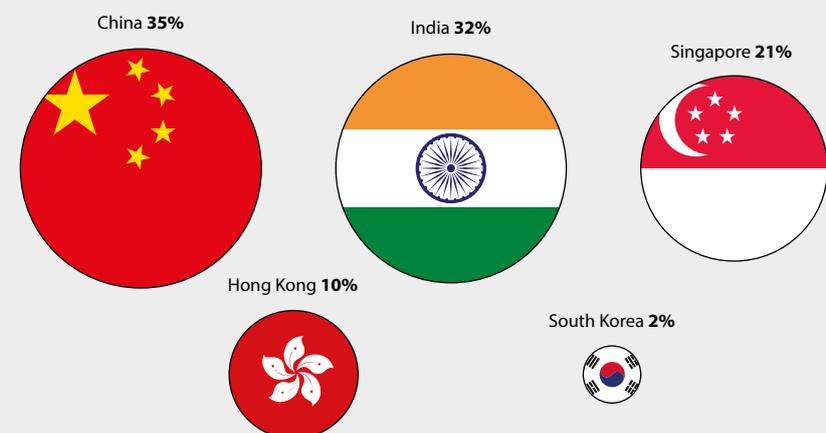


Figure 11: Please specify which country in this region (respondents who answered "Asia-Pacific")



120 per cent. Asian investment, meanwhile, more than quadrupled last year to US\$4.3 billion. Our survey found that a third of respondents expect Asia-Pacific to be the busiest fintech market, with 28 per cent choosing Europe (Figure 10).

China accounts for 45 per cent of Asian fintech investment, according to Accenture and CB Insights. McKinsey, meanwhile, estimates that the internet finance sector in China is worth US\$1.8 trillion, with more than a third of the population already using internet payment systems.

In addition to the high digital banking take-up rates among its citizens, China has also recognised that fintech can play a huge role in improving financial inclusivity and reaching under-banked citizens across a large country where the costs of building out a physical branch or broker network have historically proven prohibitive. It has thus adopted a favourable regulatory approach to fintech, with the People’s Bank of China openly expressing its support for tech companies developing internet finance services.

“There is so much that fintech companies can gain in Asia. It is a massive market that is comfortable with using technology,” says

Sonia Palmieri, head of business development at Smartkarma.

“A large number of people don’t have bank accounts, so fintech is ideally positioned to open up to new customer bases. There are also a number of people who work overseas and remit their earnings back home, so digital payments services that are easy to use are attractive to customers.”

India is also moving ahead when it comes to fintech. According to Statista data, transaction value in India’s fintech sector is expected to deliver a five-year CAGR of 22 per cent to reach US\$73 billion by 2020. The Indian government has been eager to support the growth of fintech and has launched a US\$1.5 billion fund to invest in startups. It has also introduced a range of tax incentives for fintech providers, including tax breaks for companies accepting more than half of their transactions digitally and certain reliefs on capital gains tax for technology startups.

These initiatives could help fintech tap into a fast-growing market. According to figures from the Reserve Bank of India, for example, credit card issuance in India grew 16 per cent in the year to March 2016, while credit card spending shot up by more than a quarter.

Figure 12: Please specify which country in this region (respondents who answered “Europe” in Figure 10)

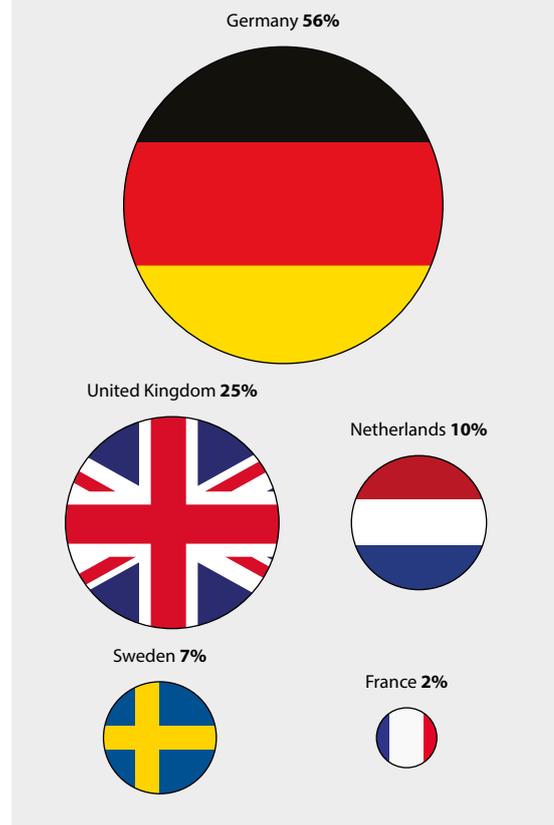
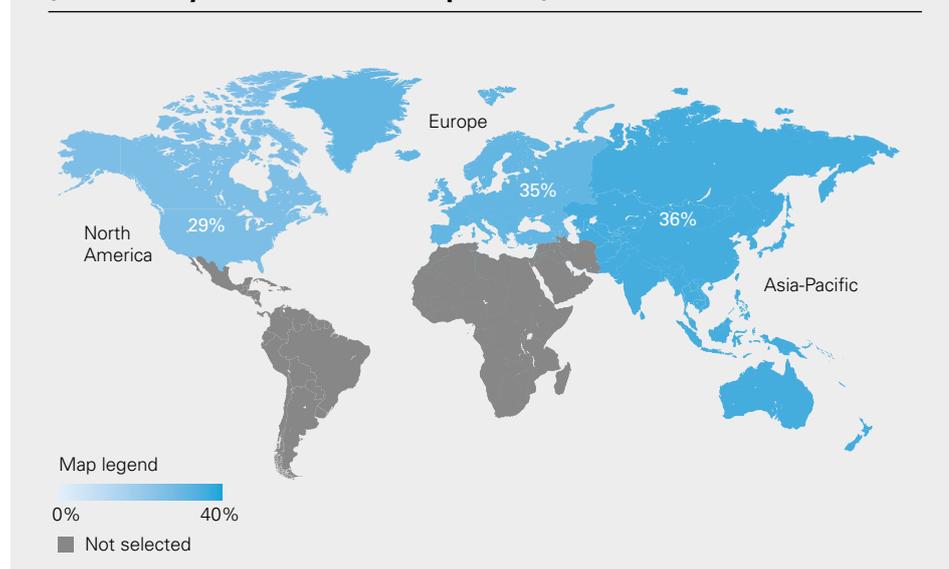
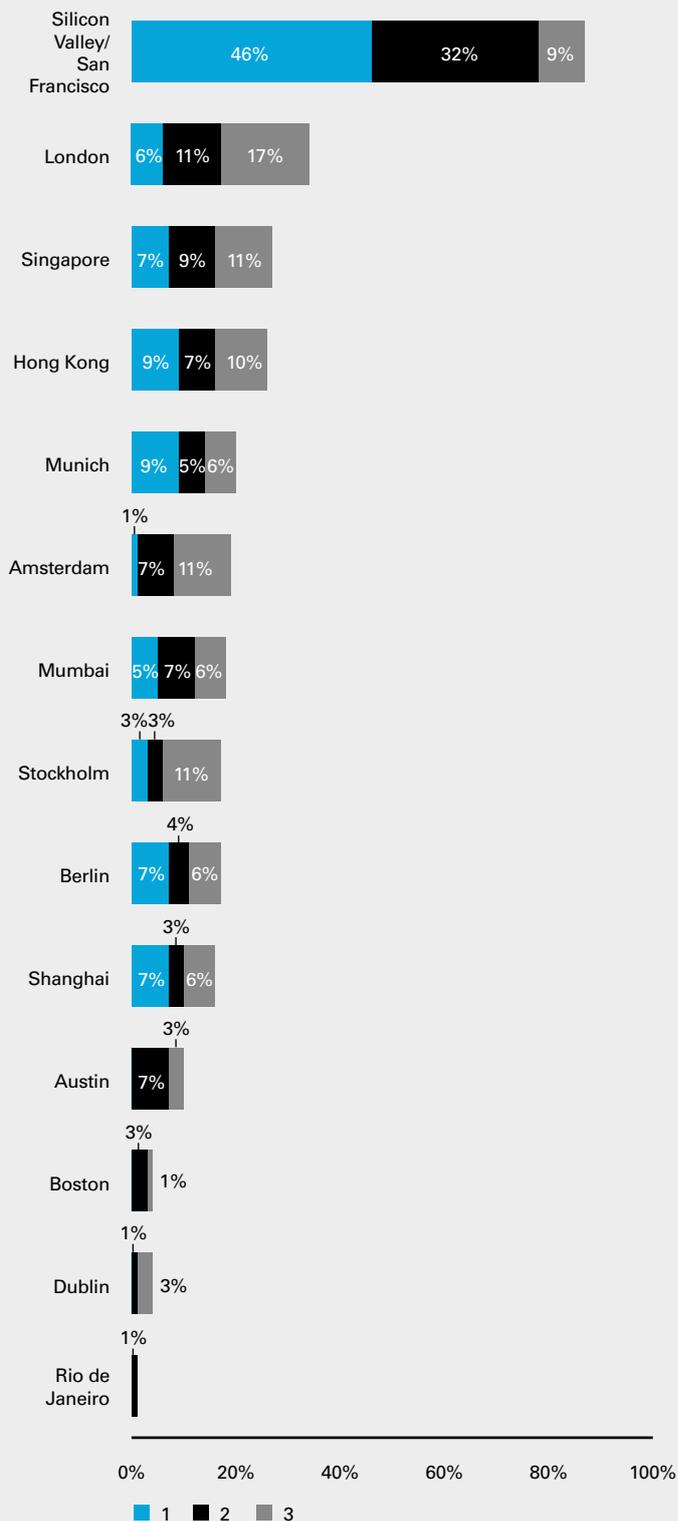


Figure 13: Which region will your next fintech deal/investment be in? (Please only select the most important)



China has recognised that fintech can play a huge role in improving financial inclusivity and reaching under-banked citizens across a large country

Figure 14: Which cities do you think will host the most attractive fintech targets over the next 12 to 24 months? (Please select the top 3, 1 = top target)



European dream

As regards Europe, 56 per cent of respondents say most fintech dealmaking activity will take place in Germany, ahead of the UK, which was selected by a quarter of those surveyed (Figure 12).

Even though the UK has adopted a favourable regulatory environment for fintech and introduced a “regulatory sandbox” for fintech companies to test out new products, Germany has enjoyed the fastest growth in fintech. According to Accenture, German fintech investment grew 843 per cent in 2015. This has been attributed to the maturing of the country’s fintech hubs in Berlin, the Rhein-Main-Neckar region and Munich, and momentum from successful funding rounds for interest rate comparator Zinspilot and consumer loan platform Kreditech. German banks, meanwhile, have also proactively moved to enhance their fintech offering by teaming up to form



843%

growth in German fintech investment in 2015. Source: Accenture



33%

say Asia-Pacific will be the busiest fintech M&A hub for the next two years

Paydirekt, an industry-led alternative to PayPal involving more than 40 banks that will facilitate interbank digital payments.

Indeed, the growth of fintech in Asia and Europe could well threaten North America’s dominance down the line. While respondents did say that they expect North America to top fintech dealmaking in the next few years, for their own deals, firms are looking to these new-growth areas. Thirty-six per cent say their next fintech investment will come in Asia-Pacific, while 35 per cent point to Europe, and just 29 per cent choose North America (Figure 13). Looking at the list of potential fintech hubs to come also adds weight to this theory—between Silicon Valley (1st) and Austin (11th), all nine other cities are based in either Europe or Asia (Figure 14).



No Brexit breakdown

The UK's decision to leave the European Union has caused great consternation within the business community. However, fintech investors and innovators appear to be taking it in their stride. Nearly three-quarters (74 per cent) believe Brexit won't impact the appetite for UK fintech deals (Figure 15).

The uncertain nature of how and when Brexit will occur means that companies aren't making rash decisions on investment yet, particularly in such a key area as fintech. "We haven't observed much change after the Brexit vote," says one global banking executive. "People will only start to make decisions when there is a clearer picture of what is going to happen. Fintech is such a key strategic driver for any financial services business—you will continue to invest when you find interesting technology regardless."

The UK's established position as a hotspot for fintech development will also assuage some of Brexit's potential negative impacts. "It is too early to say what Brexit means for fintech in London," says Kaushalya Somasundaram, global head of fintech partnerships and strategy at HSBC. "However, the development of London as a fintech hub is down to a number of factors, including a nurturing regulatory environment, access to talented people and the fact that a number of banks are headquartered in London or have large operations there. Those foundations remain in place."

Nevertheless, the UK referendum result has been viewed by some as an opportunity for other European fintech hubs to benefit. Payments startup GoCardless, for example, said in a report that Berlin is ideally placed to challenge London's dominance of the European fintech scene. Among those less likely to consider the UK for a deal/investment, the top alternative is Germany with 38 per cent, followed by the U.S. with 36 per cent. The Netherlands is the third-most popular choice with 14 per cent (Figure 16).

Some firms have already started leaving the UK. Payments startup WB21, for example, announced in September 2016 that it is relocating its EU head office from London to Berlin. At the time, CEO Michael Gastauer said Brexit was "one of the main reasons" the decision was taken. And WB21 is not alone in this. According to Berlin Partner, an agency that promotes investment into Germany's capital city, it was contacted by five London-based fintech startups on the day after the Brexit vote.

Even beyond these main markets, other European countries are keen to incentivise companies to relocate. Switzerland, for example, is proposing new rules in a bid to lure fintech startups with easier access to the market. This includes developing a "fintech licence" which would lower the capital requirements and regulatory burdens for fintech firms, and launching a "sandbox" area for new startups to road-test new ideas.

Figure 15: Has Brexit made you less likely to consider a deal/investment in the UK?

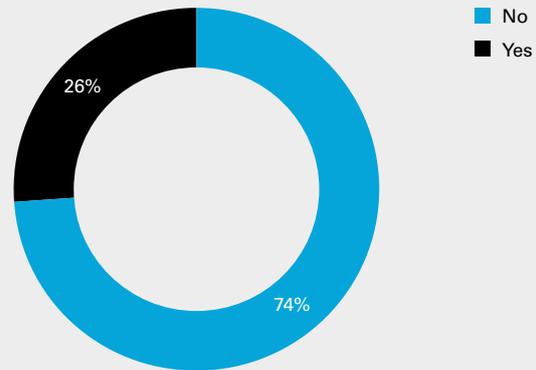
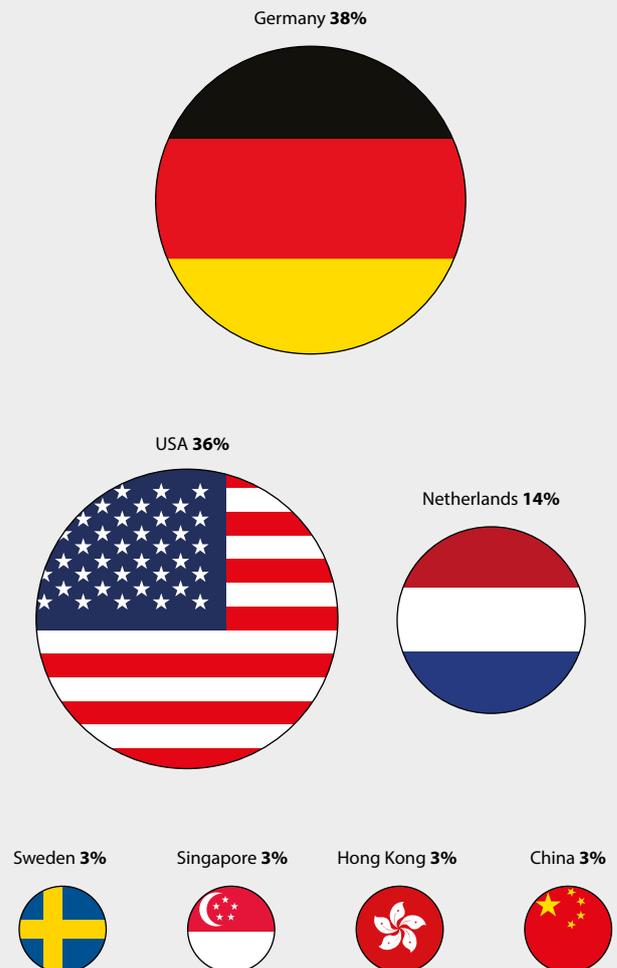


Figure 16: If your answer is yes, which country are you most likely to consider as an alternative?





Regulatory and business challenges to fintech M&A

Fintech's wealth of opportunities is attracting interest—yet the uncertainty of its future direction means the financial services industry needs to tread carefully

As exciting as the growth of fintech has been over the past decade, and as powerful an enabler as its technology has proven to be for service providers and customers, the space has inevitably encountered the growing pains that come with rapid expansion. Cyber security, investment risk and regulation are among the main issues that fintech has been grappling with as it has increased in size and become more influential in financial services.

For example, banks and regulators have expressed concerns about the safety of customer data held by

banks being made available to third-party fintech providers for use on their apps. New York's Department of Financial Services has gone so far as to request input from other regulators on the issue. There is a lack of clarity on whether customers will be reimbursed by the Federal Deposit Insurance Scheme (FDIC) if data is hacked from a third-party app.

On the question of investment risk, meanwhile, huge drops in company valuations such as Lending Club in the U.S., the demise of UK mobile payments company Powa and the failure of high-profile crowd-funded companies such as Rebus and Zano have given investors reason to pause. Further, differing regulatory approaches to fintech across key jurisdictions have also been a challenge.

Regulation in fintech

Developing an appropriate regulatory framework for fintech is no easy task for financial services watchdogs.

Existing financial regulatory frameworks are ill-equipped to oversee dynamic and rapidly changing fintech companies, but at the same time need to ensure that customers are protected and that there is a level regulatory playing field for fintech business and financial services companies that are already regulated. There is a delicate balance to be struck between robust regulation and fostering innovation.



Existing regulatory frameworks are ill-equipped to oversee dynamic and rapidly changing fintech companies, but at the same time need to ensure that customers are protected



31%

highlight lack of regulatory clarity/responsibility as the main regulatory issue



59%

do not think fintechs should be subject to tighter regulation

"Regulation is a big challenge when technology is moving so quickly and developing across so many different jurisdictions. It is difficult to read where regulation is going and what it will look like in the future," a European banker says. "Once that picture becomes clearer, it will be to the benefit of the industry and will encourage more investment."

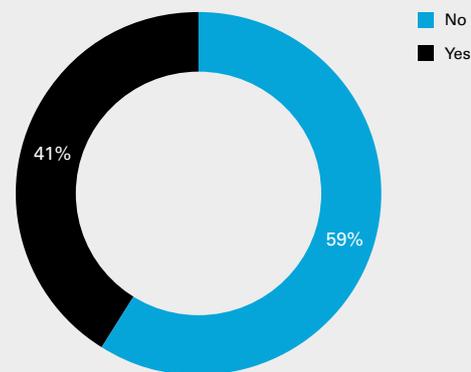
As it stands, fintech regulation differs markedly from jurisdiction to jurisdiction. In the UK, the Financial Conduct Authority (FCA) has been very supportive of fintech, laying on significant support for startups going through the regulatory process for the first time. The FCA has also set up a "regulatory sandbox," which allows unauthorised firms to obtain restricted authorisation to test innovative products or services in a live environment. It also assists authorised firms in a number of ways to test innovative products or services that may not easily fit into the existing regulatory framework.

"Regulatory innovation is as important as technological innovation if fintech is to continue progressing," says Alastair Lukies, chairman of Innovate Finance, an independent not-for-profit membership organisation serving the global fintech community. "This is also a new area for financial regulators, but there is a recognition that they can afford to be open to innovation without losing control."

Figure 17: What are the barriers to fintech deals from a regulatory perspective? (Please select the most important)



Figure 18: Do you think fintech businesses should be subject to tighter regulation?



Some jurisdictions are not as amenable, however. BaFin in Germany, although supportive of fintech, has been more cautious and reluctant to offer special arrangements for innovative fintech firms. On its website, BaFin notes that, “The challenge... is not to stifle innovation through excessively strict regulation on the one hand, while at the same time preventing these innovations from voiding the supervisory principles on the other, since [fintech firms] do not operate in a vacuum. Their business models also need to be in line with the regulatory requirements and consumer protection.”

There is less clarity in the U.S., the world’s largest fintech market. It’s difficult to identify which of the many federal and state regulators should monitor the sector, and how to get them to work together. The Office of the Comptroller of the Currency (OCC) is currently undertaking an initiative in order to “improve how the OCC evaluates innovative products, services, and

processes that require regulatory approval and identifies potential risks associated with them.”

As for which regulatory or compliance issues respondents find most challenging, data protection tops the list (26 per cent), while 14 per cent identify consumer protection as the key challenge. Elsewhere, 12 per cent say intellectual property (IP) issues are particularly challenging. Twenty-five per cent identify other areas including money laundering and capital controls (Figure 19).

Data is a central and valuable asset for many fintech companies. This means that data protection is becoming an increasingly prominent issue as more and more information about customers, businesses and other stakeholders is stored online—indeed, more than a quarter of respondents cited data protection as their main regulatory and compliance challenge.

Failure to comply with data protection regulation can prove costly in the fintech space in both financial and reputational terms. Online payment startup Dwolla, for example, was fined in March 2016 by the Consumer Financial Protection Bureau for allegedly misrepresenting how it protected the data of its customers.

In the UK, these issues are only going to become more pronounced as the industry becomes more reliant on the free flow of data.

In August 2016, for example, the Competition and Markets Authority told the largest retail banks in the UK that they must develop and adopt an open application programming interface (API) banking standard in order to enable customers to share their data with third-party app developers and competitors within the next two years in order to help customers find better deals.

Striking a balance between the need to be more open with data and the need to keep data secure is likely to be a major challenge in the fintech sector for the foreseeable future. Data protection is only likely to become more serious. The General Data Protection Regulation (GDPR) enters into full force on 25 May 2018 and brings with it

maximum fines of up to €20 million or 4 per cent of worldwide turnover—whichever is greater.

Assessing and calculating the unknown

Evaluating the risks associated with fintech assets and the values of such assets is a major concern. Fintech companies rely heavily on intangible assets such as software, databases, data, know-how and business methods. More than half of respondents (54 per cent) feel that doing due diligence on such assets is one of the top three biggest challenges to fintech deals (Figure 20).

Working out who owns the intellectual property rights or other rights in such assets is, for instance, usually complex and often requires rather extensive fact-finding exercises. It can also be difficult to assess the risks related to such assets, including potential open-source software issues, the danger that the rights in such assets will be infringed by third parties, or the risk that their use infringes third-party rights.

In addition, because fintech companies are so reliant on technology, it is likely that patent trolls will increasingly target them with the aim of extracting money through forced licensing arrangements by threatening to enforce patents primarily obtained for that aim. Establishing the value of intangible assets—which typically represent a large portion of the overall value of a fintech company—is another big challenge. For example, accurately vetting the growth potential of fintech startups that may not even be profitable at the time of acquisition can seem like a shot in the dark.



Figure 19: Are there any specific regulatory or compliance issues you find challenging?

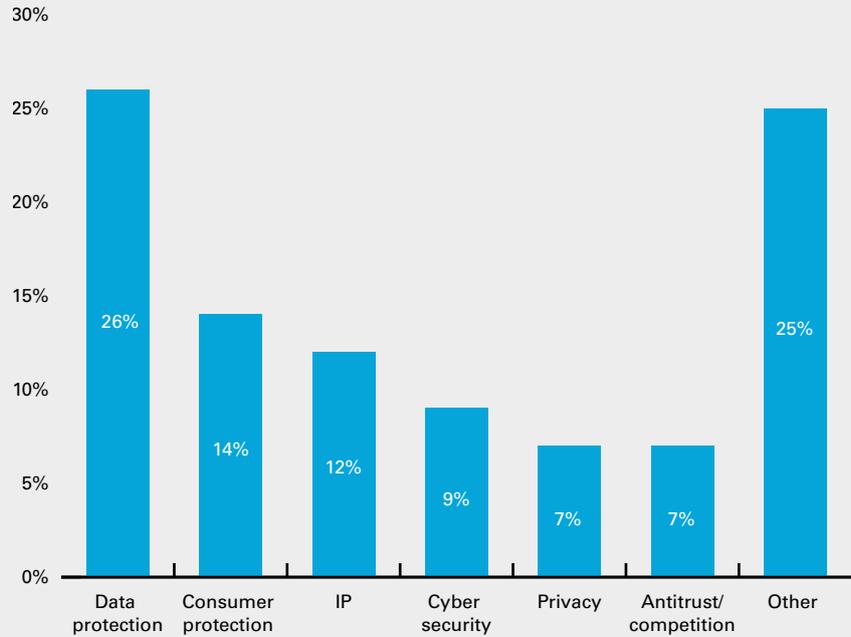
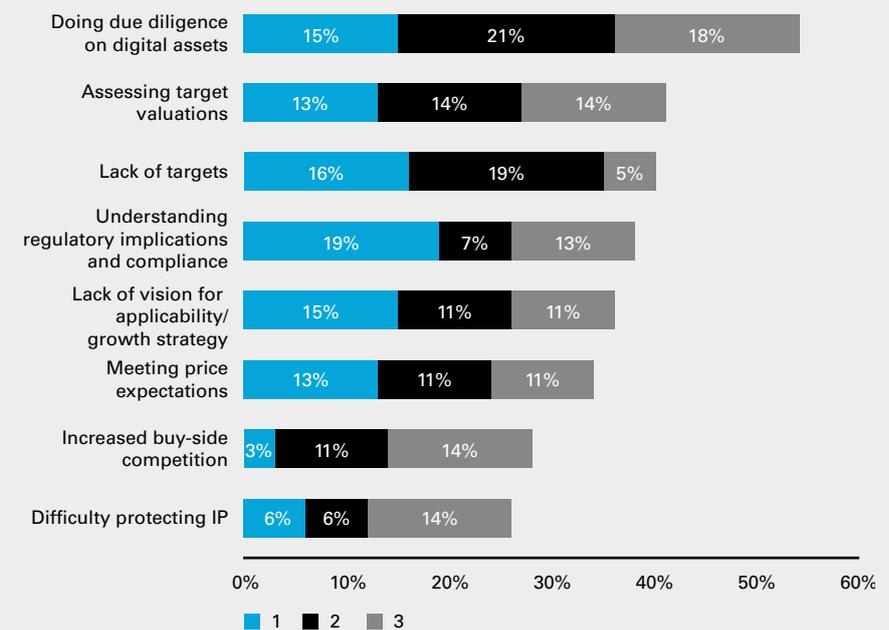


Figure 20: What do you perceive as the biggest challenge for fintech deals? (Please select the top 3, 1 = most important)





The future of fintech M&A: Not just a ripple

Challenges may lie ahead, but nothing can stop the inevitable march of fintech dealmaking

Fintech has already proven its value and will play an undeniably large role in the provision of financial services in the future. According to Accenture and CB Insights, there are already at least 20 fintech unicorns—private companies worth US\$1 billion or more—in operation.

This is in addition to the fintech companies that have already listed—such as payments company Square, which went public in

November 2015 with a valuation of US\$2.9 billion—and are worth more than many traditional financial services businesses. Fintech is now firmly established as a successful sector in its own right. And research from Technavio suggests that the global fintech investment market will grow at a CAGR of 54.83 per cent between 2016 and 2020. The survey findings underscore this optimism, with 77 per cent saying the level of fintech deals will increase during



20

fintech unicorns already operational.
Source: Accenture/ CB Insights

the next 12 to 18 months. This figure rises to 88 per cent for more than three years (Figure 21).

Looking ahead

Financial services firms and investors alike are keen for deals in various areas of fintech, as players try to come to terms with new technological capabilities and react to changing consumer and infrastructure dynamics.

Fintech investors have identified the core, proven services and platforms that will attract investment, such as payments and digital lending. These seem to centre around P2P finance, payment services and blockchain.

P2P's growth prospects continue to thrive, especially in this era of low interest rates. According to research from investment bank Liberum, people who lend money via P2P platforms can gain returns of more than 5 per cent per year, compared with the base rate of 0.25 per cent.

However, financial services players are keenly aware of the potential of what is to come. Blockchain and distributed ledger technology, for example, are still relatively nascent but hold great promise for banks and insurers. Blockchain, which records and saves data by storing it in an open-access database maintained across thousands of computers, has the potential to significantly enhance the security and speed of transmission of financial data. This is already attracting attention from major firms, with Standard Chartered investing

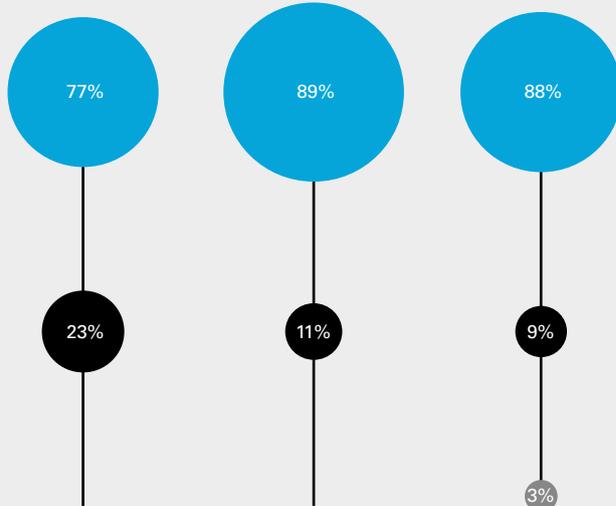


28%

think speciality financing will be the biggest fintech M&A hotspot

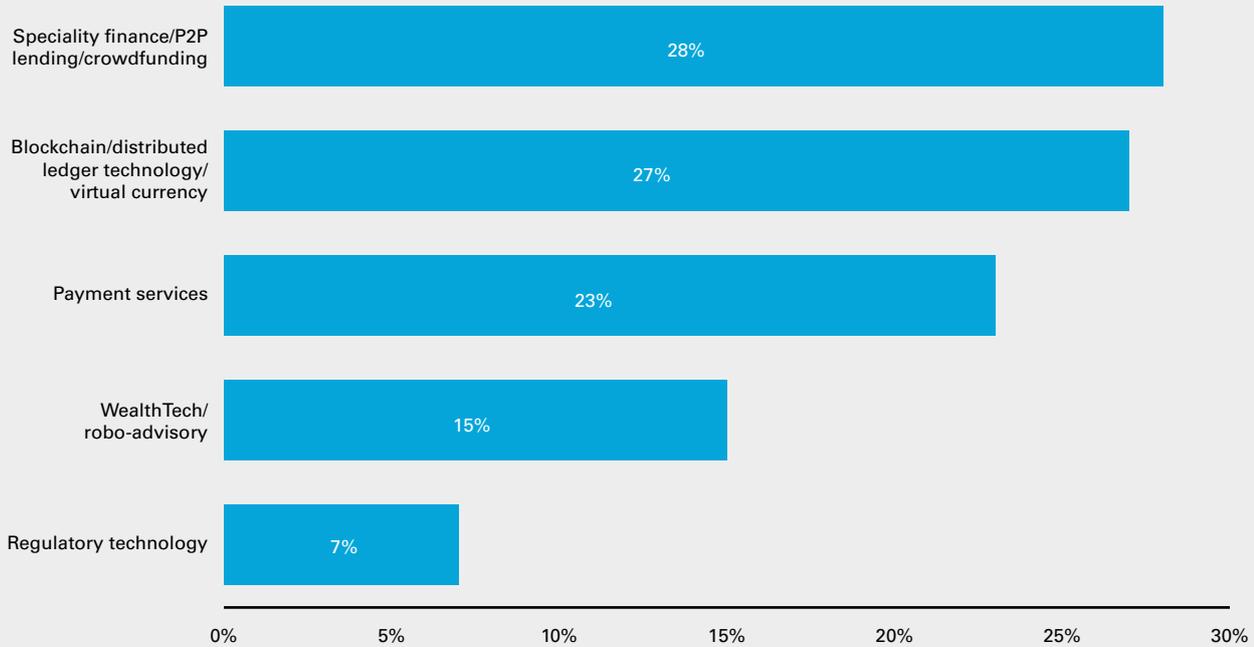
Figure 21: What do you think is going to happen to the level of fintech deals?

Next 12 to 18 months Next 18 months to 3 years In more than 3 years



● Increase ● Stay the same ● Decrease

Figure 22: Which fintech sub-sector do you think will see the most dealmaking activity? (Please select the most important)



in distributed ledger firm Ripple in September 2016.

The US Federal Reserve recently commissioned a landmark study to examine how blockchain can speed up electronic payments while making them safer and more widely used. Tech company R3 CEV, meanwhile, has secured an agreement with more than 50 of the world's leading financial institutions to join a consortium that will investigate distributed ledger technology. R3 has also worked with 11 global institutions on an experiment where there was an exchange of tokens across a private network without the need for a third party to verify the transaction.

Payment services, meanwhile, remains a hotspot too, albeit a maturing one. PayPal, Alipay and Worldpay are billion-dollar public companies; technology giants Apple and Google have moved into the space using their technology platforms; and there is still a lively ecosystem of younger payment services companies, such as iZettle

and Stripe, that are winning business. This is enticing investors, with private equity firm TCV leading a US\$180 million injection into cross-border payments company Payoneer.

"Technology has changed everything," says one European banker. "Payment applications provide consumers with multi-bank access through a single portal, and credit and equity funding can be raised using digital peer-to-peer lending platforms and crowdfunding. Enterprise resource planning and bookkeeping have been transformed too. There is huge scope for future dealmaking across all of these areas, as institutions move to buy in technology or understand market trends." For banking, it could also herald a commitment to sharing fintech capabilities. Indeed, distributed ledger startup Ripple announced in September 2016 the launch of the Global Payments Steering Group, with founding members including banking giants Bank of America Merrill Lynch and Santander. Its purpose is to "oversee

the creation and maintenance of Ripple payment transaction rules, formalise standards for activity using Ripple, and other actions to support the implementation of Ripple payment capabilities."



There is huge scope for future dealmaking across payment applications, peer-to-peer lending platforms, crowdfunding, enterprise resource planning and bookkeeping, as institutions move to buy in technology or understand market trends

Fintech funding and valuations

Investors are set to pour even more capital into fintech's growth, but valuations are a cause for concern

Fintech investment and financing have increased hugely during the past five years, from US\$1.7 billion in 2010 to US\$22 billion in 2015, according to Accenture and CB Insights. And 99 per cent of respondents believe that the volume of fintech fundraising will increase over the next 12 months—58 per cent saying considerably (Figure 23).

As capital flows into fintech, however, valuations increase and investors have begun to consider whether the sector is frothy after companies such as Powwa, valued at more than US\$2 billion in 2015, ended up in administration less than a year later. The share prices of Square and peer-to-peer lender Lending Club, meanwhile, are now below their original listing values.

Venture capital investment in fintech has also stopped increasing, another indicator that valuations could be full. Data from KPMG and CB Insights shows that, in Q3 2016, global VC-backed investment in fintech was less than half of what was seen in Q3 2015. Over half of respondents agree that valuations are too high, although a substantial minority say the pricing of fintech assets is well-balanced, indicating that a correction has filtered through the market (Figure 24).

However, companies do need to be careful what they pay for, as it could cause issues for balance sheets. For example, in June, Lending Club announced that it was taking a writedown of up to US\$40 million on the 2014 acquisition of fellow fintech firm Springstone Financial for US\$140 million.

Interestingly, more than half of respondents say fintech companies are overvalued, yet an overwhelming 95 per cent expect valuations to continue to rise (Figure 25). While this could point to the emergence of a potential bubble, it could also reflect a mixed picture across different regions. As the pace of investment in mature markets has slowed—which is likely to impact on valuation expectations—fintech investment

in Asia has continued to show strong growth, suggesting that valuations could continue to go up as well.

Indeed, the need to keep up to date with the latest technological trends is often all that is needed for money to flow. "The business that fintech has been able to achieve is more than was expected and the changes they have got in after partnering with fintech are outstanding," explains a managing director of an asset manager. "The valuations are driven by demand and competition, neither of which is coming down anytime soon."

Figure 23: Do you think fundraising for fintech firms will increase over the next 12 months?

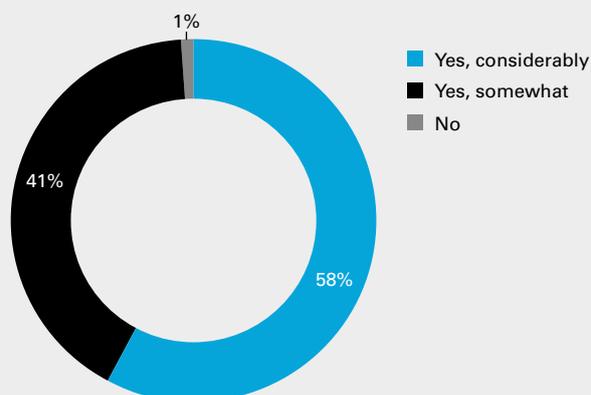


Figure 24: How do you rate fintech valuations currently?

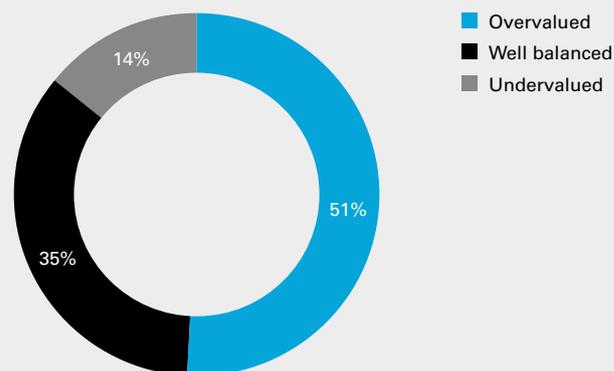
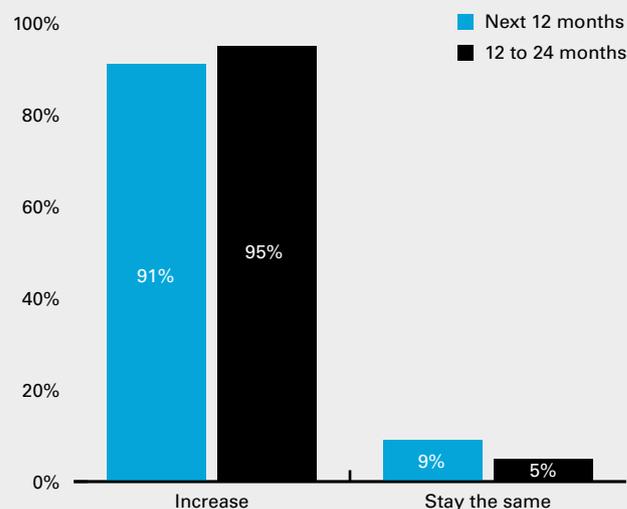


Figure 25: What do you think will happen to fintech valuations in the near future?



Outlook: Four key trends that will drive future fintech M&A

Fintech has matured. As it has evolved, so has the way in which financial institutions approach it from an M&A perspective

Financial institutions that initially viewed fintech startups as threatening competitors now recognise that these businesses can in fact help deliver services faster, cheaper, more securely and in a more customer-friendly manner. Fintech has moved from being a disruptor to an enabler, and the opportunities for the development of technologies and applications across financial services are almost limitless.

But rather than using M&A in the classic sense as a buy-out tool, institutions are now beginning to see fintech deals as a way to address a wider set of strategic objectives. This evolution—some would say revolution—over the past few years provides tremendous opportunities for M&A and dealmaking in addition to seed investment and growth capital. As the interaction between fintech and established financial services institutions continues to increase, four key trends will underpin M&A in the space.

Collaboration—rather than competition—will drive M&A. Financial services companies across the board recognise the

value that fintech can bring to their businesses. Key to unlocking these benefits will be establishing standardised platforms or technology across the finance sector. Instead of competing with each other and fintech startups to secure the next big thing, stakeholders will work on deals together to ensure that new technologies can be used across the industry as a whole (or among select groups of market participants) rather than by isolated individual companies.

Smaller deals will dominate.

There is no such thing as a “killer app” that can do everything a bank, asset manager or insurer does, so the pursuit of large mega-deals is less compelling strategically. The risk of a multibillion-dollar investment being disrupted or surpassed by a new technology is plausible. M&A, including minority stakes and joint ventures, is one of the levers that institutions will use to explore the market and reduce the risk of being blindsided by new technological developments.

Fintech funds and incubators will expand. The funds model—in which an institution cornerstones a fund to invest in fintech rather

than investing directly—has already proven popular with BBVA, Santander, Commerzbank and Unicredit, and more are likely to follow suit. In addition to removing the integration risk that comes with a direct investment, a fund model allows financial institutions to spread their capital across a range of businesses and avoid putting all their eggs in one basket. Once a concept has proven itself, the door towards ownership or partnership will open. For banks restricted by regulation from investing through funds, incubators and accelerators offer similar routes to market.

Big banks will work together for fintech. More and more established players in financial services, such as banks and brokers, are forming joint ventures and teaming up with peers and fintech startups to develop fintech solutions jointly. The use of blockchain and other new market infrastructure is just one example.

It is clear that fintech M&A and investment deals will grow exponentially. The opportunities are almost limitless.



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