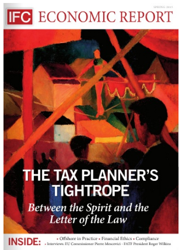






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### Due Diligence and the Future of Financial Institutions

By L Burke Files, DDP, CACM, President Financial Examinations & Evaluations, Inc (01/06/2015)

I have spent the last two months traveling around Europe, the Middle East and Africa looking at trends in finance. I have been looking at the economies shaping finance, how customer demands are shaping finance and how technology is both attempting to address these issues as well as meet customer demands and expectations. The interplay of all of these market forces and technological change are not only, complex – they are complicated as they begin to interact with one another and shape abilities and offerings.

If I have one solid conclusion – it is all about the technology. It is not just retail finance, but private too.

You are going to have more technology and fewer employees. As technology's ability increases more technological services will be deployed. The demands are forcing abilities and new abilities are creating fresh demands. Those financial institutions failing to deploy the technology will have a higher costs structures and lower service profile. Not an appealing competitive strategy in a competitive market.

From our work and devouring plenty of fish, (brain food) our future technologist practically lives on fish- we have come up with trends already manifesting themselves or that will manifest themselves.

The financial services of the future will be on mobile devices. For example, a mobile device will be gathering investment opportunities based upon preselected markets and opportunities to monitor on an instantaneous and ongoing basis. The data will be presented, partially analysed as well as providing raw data downloadable for further processing. The financial service will help their customers with bulk access to market data and allow their customers to customize what they monitor and how they analyse the data.

There will be mobile device applications, if you will, an electronic compliance officer, that warns the user when making financial choices outside of pre-specified plans or the norm, in real time. A red line stopping activity – not just a red flag altered to what has already occurred. For example, if a client tries to execute an unsuitable market order, an

automated Know Your Customer and Suitability Application will block the transaction.

A financial planning tool to aid with savings will also exist. For example if a customer makes an impulse buy the application will remind the customer what they're trading off in terms of spending now or saving for later.

All communication with the financial institution, financial professionals and their private customers will be encrypted – period. No – open communication, be it by phone email, text messages. Part of the initial client on boarding will be loading the client's mobile devices with those apps and tools to ensure secure communication.

Customers' choices will drive the services and products offered. A new customer may wish to have aggressive financial management of the assets on hand and be able to shift near instantly between investment choices. They will set their custom criteria such as high growth, one or more of the companies working in a developing country or even sin

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stocks such as alcohol, gambling, and tobacco. But it will be their choice.

The KYC demanded on all clients on boarding will continue to grow in scope and depth. The flip side of this is now these very same expenses can be a source of revenue. Financial institutions could become identity vouchers having checked and doubled checked a background – like a seal of good background keeping. Combine this with the ability to analyse and use the information on their clients, could provide an insight to a client on simple issues such as creditworthiness or the need for additional financial products, like insurance. A good financial institution will really know their customers. This information when aggregated can also be used for marketing or for possible screening applications, such as for employment. Mind you some laws and or permissions would need to be addressed.

Financial institutions will be replaced by digital financial/informational platforms that are run almost entirely by algorithms and applications. Financial institutions of the future will essentially be technology companies that mediate information, aggregate store and dispense credits, and through this learn about and analyze a customer's preferences on products, services, and markets.

The client account of the future will be institution-agnostic: an open ecofiscal system where a client manages their current and future financial needs. Financial institution accounts will be like your cell phone number, it is still your account number even though you and your account can move from one financial institution to another. The account will represent your financial identity and you will keep it regardless of who is providing the service, be it a financial institution, a large tech firm, or a new company. While this is a prediction I can tell you this is happening in Kenya with M-Pesa – a powerful tool to be sure. One can spend, save, borrow and invest all with a mobile device and an M-Pesa account. It is amazing.

Blockchain technology will be widely used to distribute, verify and record a wide-range of financial services, making the financial system more decentralized, buy and sell currencies, investments, copyrighted material, as well as make and receive payments for same. Some risks will be eliminated, while some new risks will be introduced. We might understand those risks we will choose to eliminate, but I am not yet sure we understand those risks we will inadvertently create. I can think of Bitcoin where you know you have 100 Bitcoin in your Bitcoin wallet, but with no way to remember your key or access your key, the Bitcoins remain visible yet irretrievable.

Social investing and trading platforms will become more common and more sophisticated. New options will arise with social sourced; lending, borrowing, and exchanges on these platforms. We see some of this emerging with crowd funding applications on choices for equity and debt. A financial institution's information on their clients harvested from their KYC obligations and the client's past behaviour provide an opportunity to provide meaningful ratings on and for the participants on these platforms.

Decentralized and crowd-sourced loans, mortgages, and risk management products will become the norm. Traditional middlemen will be cut out, with institutional investors providing funds to consumers or businesses directly through online platforms. Think of how many middlemen have been cut out of travel (Expedia), auto buying (eBay), shopping (Amazon), small transactions (PayPal), why do you think traditional financial institutions might be immune? Even now the shadow bankers are three times the size of traditional financial institutions. The shadowing banking choices are only going to grow larger and more diverse.

Powerful algorithms will monitor the behaviour of a financial institution's data to identify external and insider security threats on a real time basis. Financial institutions will require 24/7 real time threat assessment and response that is automated – and probably outsourced to experts. You just cannot hire a security guard to protect the front door as now the front doors are all electronic.

Many of the offerings in technology will have common DNA – common programs and service providers will increase the risk of not just one electronic financial institution's robbery – but many concurrent robberies. To put it another way, as soon as you figure out a key to one financial institution's vault, you have the key to the vaults of 100.

Just a few months ago over a billion dollars was stolen almost overnight from 30 financial institutions around the world. Kaspersky Labs uncovered that an international hacking group using brand new methods to overcome security systems and steal money using the financial institutions' internal networks - something previously thought impossible for an outsider to do. An international hacking group dubbed Carbanak, uniting cybercriminals from countries including China, Russia and Ukraine, invented a new way of infiltrating networks and stealing nearly US$1 billion along the way.

The barriers to real due diligence on any of these items is going to be difficult. Many applications are not financial institution specific and are horrifically vulnerable to systemic risk.

During this great disruption and retooling of the financial institutions we will find more gaps in knowledge and understanding in our due diligence requirements. This must be anticipated. Those financial institutions that see due diligence and security as an expense and cut investment in, and dedication to, these disciplines as they face increased economic competition from the future of finance will be one group. Another group will be the innovators and early adopters deploying technological solutions before the tools have become more 'battle tested'.

It is a great time to be in financial sector due diligence as so much is and will continue to change yet so much will endure. Comprehensive due diligence, with an eye to understanding your commercial environment of today and tomorrow, has been and continues to be, that enduring philosophy when applied to be left, after the disruptions, with more than just change.