Updates
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The Pandemic and the End of Digital Transformation in the Financial Services Industry: Moving From Transformation to Digital Optimization and Acceleration

The COVID-19 pandemic altered and disrupted what was considered normal and is thrusting many companies, especially financial institutions, into a new reality where the need for intense digitization is no longer an optional strategy or an experiment. Though its long-term ramifications are yet to be fully felt and understood, the events that transpired and the adjustments that had to be made during this pandemic cemented technology as the core building block in the re-emerging financial infrastructure of the economy, generally, and the financial services industry, in particular.

While the pace of change was rapid, these recent events revealed that technology had been woven into the fabric of the financial services industry, even before the crisis. Therefore, the crisis should mark the end of any debate or discussion about the need for digital "transformation" in the financial sector. Rather, all industry stakeholders—financial institutions, regulators, fintech companies, and third-party service providers—must work together to optimize and accelerate the use of technological applications in the delivery of financial services to customers by:

1) Reimagining the new operating model for a financial institution

2) Reassessing engagement with third-party technology providers

3) Reasserting a commitment to compliance and the effective use of "RegTech"

4) Reexamining cybersecurity controls

5) Reassessing and updating business continuity and data recovery plans

6) Practicing co-evolution, a process that emphasizes collaboration over competition

Finally, in order for the use of technology to be optimized and accelerated, regulators must embrace the use of technology for supervisory and oversight purposes. While the scope of these actions may at first blush appear to be ambitious, we believe that they are imperative. These actions are not needed to simply achieve a seamless and harmonious melding of technology and financial services, but rather to ensure that the delivery of financial services by financial institutions occurs in a manner that is consistent with the opportunities and challenges of our times.

"Transform" (\ tran(t)s-?f?rm\): to change in character or condition."

Based on the events that transpired in reaction to this pandemic and the changes that occurred[1], there is ample evidence that the financial services industry has been transformed with the power of technology. The pandemic crisis forced the financial services industry to launch new capabilities, new ways of doing business and operating, new methods to cope with demands, and new tools to deal with ever-growing compliance requirements that had to be adapted to the sudden surge of the digital channel.

For the financial services industry, the discussion about the need for a cohesive and purposeful digital transformation strategy had been raging for years. Then COVID-19 happened! And the pace of change was beyond anyone's expectations and imagination. Financial institutions, which traditionally had long-term plans to scale their digital strategy, had to readjust and deal with a new reality where change happened virtually overnight. The future of digital adoption and use of technology became an immediate reality and an urgent necessity. Physical channels shut down, customers transitioned to digitally consuming financial services, and the workforce transitioned to remote working by leveraging cloud-based services and collaboration tools and infrastructure. Operational and financial workloads shifted (in part) to running in the cloud, and compliance functions had to be optimized and scaled for the online and digital world powered by data analytics, AI, and machine learning. Many fintech companies (e.g., neo-banks, lenders, and payment companies) saw growth during this time of crisis, driven by demands from consumers needing virtual and remote access to financial services. Whether the financial services industry was ready or not, *change in character or condition* happened; transformation happened—and it happened with unimaginable speed and suddenness.

Out of these challenging times and this unexpected real-life "stress test," several lessons and considerations are emerging. They require a change in the way all stakeholders—financial institutions, their regulators, and fintech companies—manage and navigate digital optimization and acceleration while working towards a more intelligent and resilient industry. We will explore these lessons and considerations in the hope to provide a clearer path from transformation to digital optimization and acceleration.

The End of Digital "Transformation"

Declaring the end of digital transformation in the financial services industry does not mean that the industry has reached a perfectly harmonious and utopian fusion of technology and financial services. It is a declaration that this pandemic crisis ended any debate that technology is and will always be an integral part of financial services. They are and will always be inseparably intertwined.

In 1989—two years before the collapse of the Soviet Union—Francis Fukuyama, an American political economist and historian, published his controversial article "The End of History." In it, he argued that the struggle over political ideologies, which propelled history for centuries, has ended because the debate over which form of government should prevail should end. With that, there is no longer a challenger to capitalism and liberal democracy. Many decried the article as a premature victory lap. For Fukuyama, it was not a declaration of an ideal form of government but an important historical evolutionary and factual event.

In a similar vein, this pandemic and epidemiological crisis should mark the end of the debate over the role of technology in the financial services industry, the end of the discussion of the "need to transform," and the end of the sluggish pace of technology adoption that has marred the financial industry for years. Transformation happened and the transformation phase should lead to a phase of intense technology optimization, accelerated deployment, and usage in the financial services industry.

For years, the discussion and debate around the role of technology in the financial industry constantly intensified with the emergence of every new technology and with the rise of fintech companies that looked to disrupt the financial sector leveraging technology. Many declared the demise of incumbent financial institutions because of their inability to adapt to the technology-driven world. Financial institutions of all sizes have been devising long-term strategies for technology adoption and have been investing—some more than others—in technology modernization. Every year was declared the "year of the fintech," and every few months, a new article gets published announcing that "Big Tech" will take over the financial sector.

Yet, with the crisis, the financial lives of most people around the world transitioned in a surprisingly orderly fashion. So far, the integrity of financial markets and the stability of the financial system, while still facing challenges and vulnerabilities, continues to withstand this unprecedent turbulence, due in no small part to technology. Recent surveys, studies, and data have shown that many financial institutions digitally transitioned their services. Payment, clearing and settlement, wholesale funding, insurance services, capital markets, lending, and other essential financial services moved to the cyberworld somewhat seamlessly. This transition is due to the fact that, prior to the pandemic, many institutions were already working (but by no means completed) on improving their data management structure, modernizing core infrastructure, embracing AI, and utilizing the cloud. These financial institutions already started a journey of modernization to optimize experiences, operations, compliance, and productivity (including resiliency and security).

Financial institutions with a clear strategy have made technology a core capability in their growth plans—not because their goal is to become a technology company but because they know that financial services must be powered by technology if they are to survive. Meanwhile, many fintech companies are seeing double-digit growth because they have already made technology a core mechanism for delivering needed financial services to customers. Also, Big Tech companies have proven to be critical partners to financial institutions by providing them with critical and essential technologies that will propel the financial institutions' innovation and growth. To date, the business model for Big Tech has emphasized collaboration over competition.[3] A new financial digital world emerged and is being stress tested.

So, why continue to emphasize "transformation" when change has already occurred as a result of these historical events? The industry has, in effect, already undergone a real-life stress test of its new technological infrastructure.

The Ultimate Stress Test and the Silver Lining

Billions were spent on digital transformation over the past few years.[3] Many initiatives were considered unsuccessful or some are still at such an early stage that their value has not been fully realized. Despite the enormous investments on technology modernization, most of the digital transformation initiatives were multi-year journeys aimed at rearchitecting the financial institutions' data infrastructure: introducing data analytics, modernizing a fragmented and old core infrastructure, embracing cloud and hybrid cloud services, or starting to leverage AI and machine learning in a variety of use cases. However, progress against the goals of these initiatives stalled or took significantly longer than expected to implement. This happened for many reasons, including the complexity of the infrastructure, the challenges associated with modernizing legacy systems, the difficulties in amassing the right internal talent to navigate such a transformational initiative, and the enormous costs needed, especially in light of shrinking margins.[4]

Progress towards digital adoption and usage was slow with little or no imminent need to accelerate it. Many financial institutions lacked the sense of urgency to accelerate digital adoption and usage despite the advocacy by many technology companies and industry consultants for such acceleration. The institutions' strategies were seen as reactionary and were being implemented only to respond to shifting customer demands and competitive threats from fintech companies, despite evidence that the adoption and use of technology could improve the financial institution's operational efficiencies and help reduce its costs. Many of the digital initiatives did not have aggressive timetables and failed to prioritize implementation.

Another reason for the sluggish pace of digital transformation is the lack of regulatory pressures and requirements on financial institutions to integrate and accelerate the use of digital tools and capabilities. Unlike capital and liquidity requirements and controls, as well as other safety and soundness measures, the use and adoption of technology is not driven by regulations. Pressure, if any, to implement a digital strategy was driven by market and customer demands, rather than by regulatory mandate. Typically, regulators exercise their supervisory powers over these institutions through various means, including by periodically stress testing the resilience of these institutions to adverse market developments. Such regulatory-mandated requirements and tests lead to the urgency behind the institutions' implementation of controls and their strict prioritization of implementation.

However, when it comes to technology adoption and usage in the financial services industry, there is neither a regulatory mandate nor a stress test to validate its effectiveness. It is a discretionary initiative left to the institutions to run, if they so choose, and to judge its extent and effectiveness. Arguably, the limited regulatory guidance that existed in the area of technological innovation and application focuses on the preservation of the regulatory status quo, rather than a parallel innovation with respect to regulatory oversight itself.

The pandemic crisis put an end to the lack of urgency and may prove to be the ultimate stress test for the financial institutions' digital transformation strategies and initiatives. Several research studies, customer surveys, and market analyses seem to indicate that despite some expected challenges and misses, the financial services industry has transitioned effectively to the digital world and is evolving its operations and business model to manage the new normal, whatever that may be. Immediately after the declaration of public health emergencies, regulators across the globe issued guidance designating technology providers who provide the infrastructure for core processing, online and mobile banking, settlement activities, and other financial services as "critical infrastructure" for essential services. Regulators also asked the institutions to closely examine their disaster recovery and business continuity plans and prioritize the coordination with their technology and cloud providers[6]. The fact that the financial sector did not experience major service disruptions or interruption presents further evidence that, for the most part, the industry has successfully transformed to a digital industrial architecture, even before the crisis.

Meanwhile, this stress test also validated the critical role that fintech companies play in the financial life of customers, individuals, and enterprises. As mentioned before, many fintech companies saw double-digit growth in terms of customers and transactions during this pandemic and several are playing critical roles in the economic recovery efforts, whether through enabling faster and safer cross-border remittances or providing small business loans under various economic stimulus efforts. During this crisis, these companies, born and raised in technology, effectively complemented the role that traditional financial institutions play and proved that coexistence and collaboration may be the path towards a more resilient and more intelligent sector powered by technology.

Unfortunately, and inevitably, every major crisis—whether it is economic in nature, a war, or a pandemic—will result in casualties both within the financial system and more broadly throughout the economy. These crises tend to eliminate the weakest institutions in the market or the ones who fail to adapt. The "hopelessly unadapted"[7] institutions—those who failed to launch their digital journey for whatever reason—will likely not be able to withstand the stress of this crisis given the economic strain that banks were already under even before this pandemic. This crisis may have accelerated the demise of certain institutions which were already late on their digital transformation journey. Several more cannot fiscally withstand a prolonged economic slowdown, deal with rapidly shrinking margins, and are dealing with historically low interest rates.[8]

Learning from the stress test, the mistakes of some institutions, and best practices from post-mortem change management principles, the following are some of the lessons and considerations that may provide a clearer path from transformation to digital optimization and acceleration for the financial services industry.

Lessons From the Stress Test and Considerations for the New Reality

"Optimize" (\ ?äp-t?-?m?z \): to make as perfect, effective, or functional as possible."

The crisis has shown that financial institutions and fintech companies can cope and actually grow in the post-crisis new normal, at unprecedent speed. To build on the evolutionary momentum, leverage the learnings from the crisis, and make the financial industry *as effective or functional as possible* in the face of this digitally transformed reality, there are some key considerations and imperatives for all affected stakeholders:

1. **Reimagine the New Operating Model.** Digital transformation is more than just the deployment of technology-powered tools and capabilities. With the shift that just occurred, institutions need to examine and redesign their operational processes and business models in light of new experiences and digital tools being used. A deeper alignment of digital, business, and operational strategies is needed to, among other things, (a) enhance the emerging customer experience and meet the demands of the new customer-engagement model, (b) empower the workforce, and (c) re-imagine product/service development and deployment cycles.
2. **Reassess Engagement With Technology Providers.** In light of their recent pandemic-related experiences, institutions should relaunch their due diligence exercise with their technology providers to reassess how these providers fit into their evolving risk management framework, their long-term business strategy, and their digital optimization plans. A new heightened level of due diligence, oversight, and performance assessment is required in light of the massive shift to the digital channel, recognizing that the level of oversight will vary depending on the systemic importance of a particular use of each technological application. Financial institutions will need to allocate trained and qualified resources to perform the oversight and management functions, access appropriate information and data from providers for monitoring purposes (e.g., availability history, service disruptions, outages, and scheduled maintenance times), agree on key performance indicators regarding the provider's commitment around resiliency, scalability and/or capacity, and establish regular monitoring performance cadence and rhythm. Considering how integral technology is to the institutions' functions and new operations, there is a need for a deeper integration and collaboration between a financial institution and its third-party service providers to manage expectations regarding every aspect of the business including capacity management, scalability, and resiliency of the systems and infrastructure.
3. **Reassert Commitment to Compliance and Double Down on RegTech.** The way that financial institutions are conducting business, operating processes, interacting with customers, and launching products and services has changed significantly. With this change comes the need to reassess how the digital shift and the new virtual environment is affecting current compliance controls and processes. For instance, are AML controls relating to customer authentication and due diligence scalable to meet the massive shift to digital and mobile banking? Financial institutions should take a closer look at technology to continue to optimize and accelerate their compliance controls and systems and therefore continue to keep pace with the ever-evolving regulatory changes and requirements and the newly emerging cyber risks and schemes. Furthermore, institutions should take a closer look at how their data and that of their customers is being used and how technology is affecting its scope of use, storage, and movement,

especially when a third-party technology provider is involved. For instance, a financial institution should be fully aware of where data is held when in the cloud, which laws and regulations control if the data is hosted and stored overseas, and how technology providers are using and accessing the institution's data. With respect to AI/ML systems developed by third-party providers, the institutions need to keep a closer eye on the functioning of the algorithm and take accountability for the outputs of the AI/ML system to ensure its proper legal and ethical deployment and usage.

4. **Reexamine Cybersecurity Controls.** The institutions and their providers must strive to evolve their cybersecurity policies and procedures to mitigate the increased risk in going virtual. The use of encryption technology that meets or exceeds international standards to protect and secure the data at all times (whether in storage or in transit), or the use of multi-factor authentication (i.e., requiring users to undergo multiple validation procedures to gain access to the service) to limit access to data, should be a given and should span the institutions and their providers. Meanwhile, the cybersecurity strategy should be reexamined to ensure that not only the technology is adequate to provide a strong line of defense, but that the security team is fully staffed, qualified (with the right technology experience), and scalable to meet the growing demands. Institutions should ensure that any technology provider with which it contracts is appropriately protecting confidential information both in transit and at rest by maintaining robust security measures that meet or exceed international standards. Financial institutions should also have in place processes to ensure effective monitoring for security threats and a comprehensive response mechanism to such threats. At a minimum, institutions need to ascertain that the provider (and the technology) is appropriately certified and maintains robust security measures and security policies, and that such security and privacy controls are aligned with the international standards and controls like the ones set out in the SOC 1 and SOC 2 assessment frameworks.
5. **Reassess and Update Business Continuity and Disaster Recovery Plans.** The events of the crisis were a blunt reminder of the critical need for practical and operational business continuity plans. The financial services institutions needed to digitally scale suddenly and with minimal risks of downtime or service disruption. Institutions also realized very quickly that their business continuity and disaster recovery plans depend to a great extent on the plans of the technology providers, especially cloud providers and collaboration tools providers. A reexamination of data backup processes and frequency, support systems, incident response plans, redundant infrastructure, scalability and resiliency of systems, and capacity are critical steps in the optimization of the technology infrastructure and systems.
6. **Practice Coevolution.** Niall Ferguson, in *The Ascent of Money: A Financial History of the World* uses the term "coevolution" in the context of financial services. He defined it as an instance where different species work and adapt together. Formally, "coevolution" is defined as "an evolution involving successive changes in two or more interdependent species (as of a plant and its pollinators) that affect their interactions." The crisis has shown that the opportunity to coevolve in the financial industry is greater than ever. Traditional financial institutions, fintech companies, and technology providers have an unprecedented opportunity to come together and complement each other to optimize and accelerate the digitization of the financial services industry. The speed of change requires a closer examination of opportunities for financial institutions and fintech companies to partner to achieve the scale, speed-to-market, and technology prowess needed to meet the digital demands of customers, among other goals. Meanwhile, technology companies will continue to collaborate with institutions and fintech companies rather than compete with them or try to displace them. Together, these entities will accelerate innovation in a compliant manner, through greater technology scale, new approach to design and deployment, and the building of a robust culture of compliance. Coevolution should replace a culture of distrust between these "species" and should prove to be an opportunity to allow institutions, regardless of their size or their IT or R&D budgets, to accelerate their path to digital optimization. For fintech companies it is an opportunity to partner with institutions that can bring scale, core competencies in financial services, and a robust culture of compliance.

For regulators, the acceleration of transformation and the transition to technology optimization means a need to adapt and accelerate their own use of technology. They need to keep pace with the increased workload of compliance oversight in this virtual world. Now more than ever, regulators need to use technology to effectively and efficiently conduct their supervisory and oversight functions, an area commonly referred to as "SupTech." Available SupTech solutions, such as data analytics tools and AI systems or other infrastructure, do and will enable regulators to scale and continue to provide the critical supervision functions. The need for investment by public agencies and governments and the need to hire the qualified talent to support the evolution of the regulatory functions is more important and urgent than ever.

Final Thoughts

"Accelerate" (\ ik-?se-l?-?r?t , ak- \): to move faster: to gain speed."

The end of digital transformation is exciting and hopefully will mark the beginning of the phases of optimization and acceleration of technology adoption, deployment, and acquisition in financial services. The crisis became a function that forced the industry to move beyond traditional and stale business models—financial institutions had to shift to new ways of working to meet customers' needs. Technology allowed the shift to a new way of doing financial business and has forever been intertwined with financial services. We have a long way to go to achieve the seamless and harmonious melding of technology and financial services. Yet the events of the past few months forced an unexpected acceleration, the momentum of which can propel our financial lives into the new normal.

Endnotes

[1] By way of example, according to Fidelity National Information Services (FIS), new mobile banking registrations in April increased by 200% with mobile banking traffic increasing by 85%. Ellen Sheng, "Coronavirus crisis mobile banking surge is a shift that's likely to stick," *Tech Trends* (May 27, 2020), https://www.cnbc.com/2020/05/27/coronavirus-crisis-mobile-banking-surge-is-a-shift-likely-to-stick.html.

[2] "BlackRock and Microsoft form strategic partnership to host Aladdin on Azure as BlackRock readies Aladdin for next chapter of innovation," Microsoft News Center (Apr. 7, 2020), https://news.microsoft.com/2020/04/07/blackrock-and-microsoft-form-strategic-partnership-to-host-aladdin-on-azure-as-blackrock-readies-aladdin-for-next-chapter-of-innovation/.

[3] Behnam Tabrizi, et al., "Digital Transformation Is Not About Technology," *Harvard Business Review* (Mar. 13, 2019), https://hbr-org.cdn.ampproject.org/c/s/hbr.org/amp/2019/03/digital-transformation-is-not-about-technology.

[4] "Mengqi Sun, Businesses Predict Digital Transformation to Be Biggest Risk Factor in 2019," *Wall St. J.* (Dec. 5, 2018), https://blogs.wsj.com/riskandcompliance/2018/12/05/businesses-predict-digital-transformation-to-be-biggest-risk-factors-in-2019/.

[5] *See* various regulatory guidance statements at:

- https://www.fdic.gov/news/news/financial/2020/fil20014a.pdf
- https://www.ffiec.gov/press/pr030620.htm

- https://www.finra.org/sites/default/files/2020-03/Regulatory-Notice-20-08.pdf
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- https://www.mas.gov.sg/news/media-releases/2020/mas-welcomes-measures-by-financial-institutions-to-support-customers-facing-the-impact-of-covid-19

[6] Term used by Joseph Schumpeter and quoted by Niall Ferguson in *The Ascent of Money: A Financial History of the World (*2008).

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