FinTech and the Future of Banking

Professor Xavier Vives
Professor of Economics and Finance,
IESE Business School

> **The potential short-term implications for new entrepreneurial startups in the financial system has never been larger**

The current rapid pace of change in the banking sector appears to be accelerating, with digitalization increasing competition, including in the adoption of different forms of digital currencies. Combined with low interest rates and the resulting pressure on bank profitability, the potential short-term implications for entrepreneurial startups in the financial system has never been larger.

Among related developments, we see the massive application of digital technologies and the emergence of new competitors. These have allowed for many new products and services and helped improve the efficiency of incumbent banks. At the same time, they have also favoured the entry of new firms, increasing competition with traditional bank business models. Startups face uncertain interaction effects, the result and impact of which depend on the market structure that eventually prevails.

Historically, banks have controlled digital forms of money and payments through regulatory protection of deposits, exclusive access to the central bank settlement system, and partnerships with credit card companies. However, the challenge today comes from a variety of digital assets that do not sit on the balance sheet of banks such as electronic wallets, stablecoins, and balances with a telecom provider. Control of these digital assets are among the competitive advantages of new entrants. Specifically, payment technology—including connections to the growing digital life of consumers and business alike—has been among the new entrants' keys to success.

Technology-based disruption has of course occurred outside of just the payment paradigm. For example, the entry of new players offering credit has provided another foothold, affecting banks through downward pressures on fees and prices and more compressed margins. This is particularly true when a country's general development

"Both banks and customers have realized that they can work and operate remotely in a safe and efficient way. The response to increased digitalization will require more investments in IT and will leave obsolete the overextended branch network of many banks, particularly in Europe"

is higher and its banking system is less competitive, but less so when the country's regulation is stricter. Across the board and by contrast, non-bank entry has not yet been meaningful in demand deposit-taking activities, possibly due to concerns about regulatory burdens. Change has been uneven, but steadfast in its growth.

A main conclusion of the recently released report *The bank business model in the post COVID-19 World*[1] is that pre-COVID-19 tendencies will be accelerated, as subdued economic growth and low interest rates persist and digitalization in its many forms continues to advance. The response to increased digitalization will require more investments in IT and will tax the overextended branch network of many banks, particularly in Europe. The result is that the sector will need a deep restructuring.

The swift shift towards a more digital world in response to COVID-19 makes clear that the speed of change may take everyone by surprise. Interestingly, large technology companies have many of the ingredients to get ahead in the post-COVID-19 world. They are digital natives, have the technology, customer base and brand recognition, as well as vast amounts of data and deep pockets.

A possible outcome is that a few dominant platforms will control the access to a fragmented customer base, each of which inhabits different ecosystems. In this case, financial service providers will compete to supply the platforms, and customers will demand services from their

platform provider. In such a future, the degree of rivalry in the market will depend on the cost of switching from one ecosystem to another. The larger the costs, the less competitive the market will be. In this world, dominant platforms could include current digital giants plus some platform-transformed incumbents.

Regulators have adapted to the digitalization disruption by balancing their fostering of competition to allow the benefits of innovation while still protecting financial stability. They must ensure a level playing field and coordinate prudential regulation and competition policy with data policies. This will require navigating complex trade-offs between the stability and integrity of the system, efficiency and competitiveness, and privacy. ■

[1] E. Carletti, S. Claessens, A. Fatás, X. Vives, *The Bank Business Model in the Post-COVID-19 World*, Centre for Economic Policy Research, 2020, https://media.iese.edu/research/pdfs/ST-0549-E.pdf

"In this world, dominant platforms could include current digital giants plus some platform-transformed incumbents"

About

Professor Xavier Vives is Professor of Economics and Finance, Abertis Chair of Regulation, Competition and Public Policy, and Academic Director of the Public-Private Research Center at IESE Business School. His award-winning research focuses on industrial organization and regulation, economics of information, dynamic rivalry, innovation and competition, banking crisis and regulation, and information and financial markets. Most recently he co-authored *The Bank Business Model in the Post-COVID-19 World*.

Previously, Professor Vives served as a member of the Advisory Board for Economic Recovery of the Government of Catalonia and Special Advisor to the Vice President of the European Commission and Commissioner for Competition. He served as President of the Spanish Economic Association, Duisenberg Fellow of the European Central Bank, and President of EARIE.

Professor Vives has been an advisor and consultant on competition, regulation, and corporate governance issues for numerous global organizations including the World Bank, the Inter-American Development Bank, the European Commission, and the Federal Reserve Bank of New York.

Professor Vives holds a Ph.D. in Economics from UC Berkeley.