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How will banking look in 10 years' time?

Just as the global banking order has changed in the past decade, the next 10 years will see a radical transformation of the industry, predicts Xavier Vives.

Threats on several fronts continue to menace banking after the 2007 to 2009 crisis: low interest rates, heavy and intrusive regulation and compliance, a severe downfall in reputation and, last but not least, digital disruption. The conjunction of these menaces makes us wonder whether banking, as we know it, has a future.

Changes are apparent. Ten years ago, the 10 largest banks by assets were based in Europe or the US. Nowadays, six out the 10 largest are based in Asia.

This accounts for the effects of the crisis and the rise of Asia but there is more. Banks have had to adapt their business models to low interest rates, low credit growth or even deleveraging, and increasing competition in retail from fintech and platform-based competitors. All this has threatened the profitability of the sector, with European banks still at levels barely covering the cost of capital.

Digital competition

The major threat, however, comes from the adaptation to the digital environment. Traditional banks have seen parts of their core business – ranging from payment services and credit to advisory services – encroached upon by digital competitors. The advantage held by nimble fintechs is that they can use state-of-the-art technology, operate a leaner business and focus on those business segments with higher returns. They also face disadvantages, such as a lack of reputation and brand recognition, the absence of a customer base, limited access to capital markets, and a starting point with not much information about customers in general.

Despite these shortcomings, the new entrants have established some bridges in the banking business, in payments in particular, but they typically lack scale. This is not the case of the bigtech platforms such as Google, Apple or Amazon, however, because they have huge installed customer bases as well as strong brands and reputations, not to mention a (very) deep purse. On top of this, they have unrivalled access to information from clients, as well as a leading edge in the application of digital technology and new advances in artificial intelligence.

Meanwhile, incumbents are burdened by legacy technologies (the mistaken bet: mainframe instead of the cloud) and heavy regulation. Their response is to try to put the client experience at the centre of the business, and incorporate technology, moving as fast as possible to cloud-based systems and making alliances with fintechs.

However, the main threat to incumbents is that 'big tech' tries to control the interface with customers using its superiority in a customer base (data) by being a gatekeeper to the distribution of financial products. If this were to happen, incumbent banks would be relegated to product providers on platforms they do not control: their businesses would be commoditised.

Some banks have already perceived this threat and offer open platforms that may incorporate products from other financial providers or form partnerships with 'big techs' (such as Amazon and JPMorgan in credit cards, or Amazon and Bank of America in loans). In any case, incumbents have some strengths, such as customer trust to keep their data secure, and accumulated knowledge on how to deal with complexity and intrusive regulatory environments. They will have, however, to overcome the important deterioration of reputation suffered because of bad practices in the run up to the crisis, which favours new entrants without this toxic legacy.

Regulatory questions

Regulation will influence the shape of the transformation of the banking industry. Most new entrants are reluctant to ask for a banking licence because of the compliance costs this entails. Banks have access to cheap funds, because they can take deposits under the umbrella of explicit or implicit public insurance schemes, but they are subject to tight scrutiny. Light regulation of entrants into the industry may foster competition, but at the potential cost of destabilising incumbents and transferring the creation of systemic risk to non-bank entities.

In the US, for example, shadow banks are taking already the lion’s share of mortgage loans originations. We know that in most financial crises, such as in 1907 in the US or globally in 2007 to 2009, a shadow banking system was at its origin. If banking moves towards a platform-based system, the risk of systemic problems deriving from cyber attacks and massive data leaks comes to the forefront. This may find regulators off-guard.

Survivors among traditional banks will have managed to transit from the mainframe to the cloud, be lean in bricks but heavy on human capital, and either become digital platforms to keep the interface with the client, or have unique products to feed the platforms that will distribute the products to the customers. What we can be sure of is that in 10 years’ time the banking industry will look quite different.

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