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Comment: Why digitalisation poses a real risk to banks

The rapid digital shift resulting from lockdown measures to combat Covid-19 suggests that the pace of change in the banking sector may take everyone by surprise

Digitalisation will increase competitive pressures on banks and constrain their profitability

The Covid-19 crisis has revealed banks throughout the world to be not part of the problem but, for a change, part of the solution. They have so far proven to be resilient, mostly as a result of the stricter capital and liquidity requirements imposed on them following the 2007-2009 global financial crisis. Today many governments are using banks to channel funds to households and firms hit by the pandemic's economic fallout.

Furthermore, governments have granted banks a temporary moratorium on implementing tougher regulatory and supervisory standards, in order to reduce the potential pro-cyclicality of measures introduced in the last two decades and avert a credit crunch. As a result, banks now have an opportunity to reverse the reputational damage they suffered in the financial crisis.

But they are not out of trouble, in part because the crisis will sharply increase the volume of non-performing loans. Moreover, as a recent report that I co-authored points out, the pandemic will accentuate pre-existing pressures – in particular, low interest rates and digital disruption – on bank profitability.

Digitalisation will now advance rapidly, because both banks and customers have realised that they can work and operate remotely in a safe and efficient way. The resulting increase in information-technology investments will render many banks' overextended branch networks

obsolete sooner than they expected, particularly in Europe. That will necessitate a deep restructuring of the sector.
Medium-size banks will suffer because they will find it difficult to generate the cost efficiencies and IT investment needed in the new environment. Although consolidation could offer stressed banks a way out, political obstacles to crossborder mergers will likely arise in several jurisdictions as governments become more protective of national banking systems. In Europe, for example, where banking nationalism has been running high (with the exception of Britain), domestic consolidation seems more likely.

In addition, banks may face renewed competition from shadow banks and new digital entrants that were already challenging the traditional bank business model before the pandemic. In the United States, financial-technology firms, or fintechs, have made important inroads in mortgages and personal loans. And in emerging markets, "BigTechs" – large digital platforms, such as Alipay in China – have come to dominate some market segments such as payment systems.

The rapid digital shift resulting from lockdown measures to combat Covid-19 suggests that the pace of change in the banking sector may take everyone by surprise. That acceleration may in turn also hasten the adoption of different forms of digital currencies, including by central banks.

By further reducing entry and exit barriers in the financial-services market, digitalisation will increase competitive pressures and constrain incumbent banks' profitability in the short run. But its long-term impact is more uncertain, and will depend on the market structure that eventually prevails.

One possible outcome is that a few dominant platforms – perhaps some of the current digital giants, plus some transformed incumbents – control access to a fragmented customer base that inhabits different financial ecosystems. In this case, customers would register their demands on a platform, and financial-services providers would compete to supply them. The degree of platform rivalry and level of customer service would depend on the costs of switching from one ecosystem to another: the higher they are, the less competitive the market will be.

Bank regulators have already adapted to the post-pandemic world by relaxing the implementation timetable for capital requirements. In addition, digital disruption will require them to balance fostering competition and innovation with the need to safeguard financial stability.

In order to do so, regulators must ensure a level playing field, and coordinate prudential regulation and competition policy with data policies. This will require navigating complex trade-offs among the system's stability and integrity, efficiency and competitiveness, and privacy.

The pandemic and its fallout will test the resilience of the financial system and of the regulatory reforms introduced after the 2007-2009 crisis. The first report by Barcelona-based IESE Business School's Banking Initiative last year concluded that these measures had made banking sounder, but that some work remained to be done, particularly concerning shadow banking.

The response to the current crisis will stretch the limits of central-bank intervention – especially in Europe, where sovereign-debt sustainability may become a more salient issue over the medium term. Furthermore, the crisis will test the eurozone's banking union, which remains incomplete without common deposit insurance.

Banks have a chance to improve their battered public image by playing a constructive role in mitigating the current economic crisis. But with Covid-19 set to accelerate the sector's digitalisation and restructuring, their future could soon become more uncertain.

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