Università Cattolica del Sacro Cuore

INTERNATIONAL SUMMER SCHOOL
BANKING & CAPITAL MARKETS LAW

Fintech and the future of financial services

Speech by Carmelo Barbagallo
Director General for Financial Supervision and Regulation
Bank of Italy

Milan, 23 July 2018

1. Introduction

Good morning everyone.

First of all, I would like to thank Rector Anelli and Professor Sciarrone Alibrandi for giving me the opportunity to take part in this important opening conference and address such a relevant issue as the impact of innovation and technology on the banking and financial system.

I am particularly pleased because banking supervisors seldom have the opportunity to interact with students and young people like many of you today. And who is most aware of the revolutionary impact of innovation? Perhaps you.

No doubt, innovation and what is known as "Fintech" are central in the financial debate. Not only can they affect the financial stability of the banking industry, as we learned in the past decades; they can also deeply influence our daily lives.

While there is a general consensus on the necessity and the urgency for the banking system to invest in innovation, it seems less clear how to integrate these investments into a coherent business model: it depends on many factors, such as market structure, bank size, the resources available in terms of financial capital, organizational structure, and (above all) the quality of the human factor.

I will try to give you a brief overview of both the development of the incumbent Italian banks and the initiatives of some new players we came in contact with while performing our licencing activity. Based on this picture, I will share with you a possible scenario about the future and the way the Bank of Italy intends to interact with the market.

2. A brief background on the Italian banking system

The Italian banking industry is slowly leaving behind the exceptionally difficult period of the last decade. Problems arose first of all from the financial crisis and the steep rise in NPLs, and were compounded by rapid change in the market for banking services in the form of increased competition from non-banks and rising demand for online services, which has contributed to creating overcapacity and has caused a reduction in the number of physical branches and in the workforce. An additional problem has been low profitability, in turn the consequence of a host of root causes.

Adjustments are under way. The problem of the high volume of NPLs is being actively tackled, also thanks to the economic recovery and to pressure by the supervisory authorities. NPLs have been steadily declining since the peak of 2015; they have now reached 5.1 per cent of total loans, net of provisions, and are expected to decline further in the coming years, according to the banks' plans, also thanks to the reduction in the flow of new NPLs.

Structural adjustment is under way in a bid to reduce overcapacity. From 2008 to today, the number of branches has decreased by 17 percent and the number of employees by 21 percent. Profitability turned positive in 2017, thanks to a significant drop in loan loss provisions and to a decline in costs; the annualized return on equity (ROE) jumped to 4.1 per cent, net of extraordinary income. The results for the first quarter of 2018, which are available for the main banking groups, improved further. Capital adequacy, close to 14 percent in terms of CET1 ratio, has almost doubled during the last ten years, also thanks to material capital injections. The gap with respect to the euro-area average has narrowed further.

In this environment, banks need to face the challenges and exploit the opportunities brought about by the digital revolution and Fintech. Improved connectivity and communication, swift changes in the socio-economic scenario and transformations in the methods of delivering products and services to end-users are dramatically changing the lifestyle of each and every one of us; they are fundamental drivers of the evolution of our societies. Not surprisingly, they also contribute to a reshaping of banking markets.

What I have just said makes clear that the digital revolution has been imposing difficult changes on the banking industry. At the same time, digitization cannot be stopped, so adjusting to it is imperative, no matter how difficult this may be. Furthermore, this adjustment can represent a key factor of success for banks that are able to exploit it. It can be instrumental to improving efficiency, supporting profitability, expanding the services offered to clients, and improving their quality; in short, it can completely reshape banks' business models.

As we have gradually recovered from the crisis, I believe that we now have the right conditions for banks to successfully face these challenges and seize these opportunities.

3. The challenges and opportunities of the digital revolution

I argued earlier that the adoption of new technologies is not just a matter of choice for banks. A growing share of customers is comfortable with using new technologies to organize their lives. They seek products that are easy to access, work faster and on which they have more control, and would be unwilling to go back to the physical branch concept. Those belonging to the new generations, notably Millennials and digital natives, have little or no experience with traditional, physical banking channels, and are very hard to reach without digital technologies and online services.

Indeed, banks are reacting to this changing environment. They have adopted online banking, and are shifting the distribution of "standard" services to online platforms, via multichannel networks. This allows them to reduce the number of physical branches, and to allow the remaining ones to specialize in the supply of high value-added services (e.g. private banking, corporate finance, etc.). Technology is being leveraged to improve the efficiency of middle and back office processes, and to provide more effective risk management tools. Important initiatives are being developed in the fields of Robotic Process Automation, Blockchain, Machine Learning and Big Data.

In this environment, Fintech technologies and products can be instrumental to improving the quality of the services offered to clients, providing an important competitive edge. They can also open opportunities to fully exploit the advantages of an integrated European market for financial services, since they facilitate the distribution of retail products and services on a cross-border basis.

However, digital technologies can be a threat if banks fail to fully exploit their potential, leaving room for new competitors. Compared with the newcomers, banks still have competitive advantages, such as long-lasting customer relationships and critical information and financial skills. But these advantages can be gradually eroded by technology: online customers are much more reactive than traditional ones to competitive offers, and more prepared to switch to another provider of banking services. Furthermore, tech firms have a comparative advantage in dealing with massive volumes of data on firms and individuals, which can then be used in providing banking products – e.g. for credit screening purposes.

In sum, in the current environment, a wait-and-see strategy is a risky option for banks. More specifically, they face a difficult choice between alternative risks. Technologies evolve at a very fast pace; solutions that are considered highly innovative in a given moment can quickly be made obsolete by further technological developments; this entails the risk of making wrong investment choices. However, a wait-and-see approach exposes banks to the risk that competitors armed with the winning technologies will gain significant market shares. Indeed, new players have begun to enter markets in which banks had enjoyed a virtual monopoly, such as in payment services. These operators are often equipped with more agile structures and an ability to quickly adapt to a changing environment. Furthermore, they typically face a lighter regulatory burden. Hence, the risks for incumbents are not just theoretical.

Faced with this difficult choice – undertake risky investments or risk succumbing to new competitors – banks are adopting different approaches to innovative technology. The spectrum of available options is wide: developing in-house technological solutions; partnering with new entrant Fintech firms; collaborating and cooperating with other stakeholders; opting for a complete outsourcing of financial innovation; or participating in business incubators or accelerators.

The choice between these options is by no means trivial. It may depend on the nature of each specific project, on the level of maturity of the technology adopted, or on the bank's key features, such as size and business model. Outsourcing remains a frequent alternative to in-house solutions, especially for smaller banks with limited resources. Indeed, when a large investment is needed, size becomes an important element of success. This represents yet another incentive for industry consolidation or, at a minimum, for joint ventures aimed at cost (and risk) sharing.

Another consequence of digitization is that it tends to increase the exposure of financial intermediaries to ICT risks. This encompasses the risk of failure of ICT hardware or software components, weaknesses in ICT system management, business continuity risk, and cyber risk. Recent experience has shown that these risks can bring a financial intermediary to its knees in the same way as – and perhaps more rapidly than – typical financial risks. Ensuring ICT infrastructure security and resilience requires, again, costly investments.

New risks also entail organizational and governance challenges: internal control functions need the appropriate tools to identify and manage these new risks; management bodies need to understand them, and be able to assess alternative mitigating solutions. Organizational innovations have also been adopted. The most common include the set-up of cross-functional structures (e.g. a digital innovation unit) and the appointment of innovation specialists in various core business units. The focus on staff specialization is another common element observed among banks that have invested in new technologies. Over the last two or three years, these banks have launched significant recruitment and retraining plans for their technical staff. Initiatives include collaboration with research centres and universities.

A recent survey of Fintech initiatives conducted by the Bank of Italy reveals that there is a lot going on but that the value of Fintech-related investment is still low. Almost all projects based on innovative technologies are in the implementation or prototyping phase and their financial impact is limited. Material changes are not yet apparent.

4. Fintech and the role of the authorities

Fintech offers wide-ranging possibilities. Although the benefits of technological change may require time to fully materialize, innovation can contribute to reducing costs and information asymmetries, increasing efficiency and competition, and widening access to financial services.

National authorities are interested in these beneficial developments. They are aware of the fact that the development of Fintech can deeply affect the ability of the financial industry to evolve and prosper, and that their decisions will influence these developments. At the same time, authorities are also concerned about the potential risks that may emerge for the financial system, for consumer protection, and for the economy at large.

Intense activity is under way at international level to reach a harmonized approach to Fintech regulation. Obviously, this is especially true within the SSM. The Bank of Italy is playing a pro-active role in international and EU committees and bodies in order to harmonize a common framework of rules and supervisory practices, to support the development of Fintech, and to enable the establishment and evolution of a Fintech ecosystem.

In spite of this effort to harmonize the authorities' stance towards Fintech, the set of rules governing it is still largely incomplete. Moreover, there are doubts about the interpretation of existing rules, as Fintech activities are often difficult to classify according to the old concepts. For instance, peer-to-peer lending bundles together payment, information and technical services. This leaves a margin for interpretation and uncertainty.

Thus, there is still ample room for manoeuvre at national level, and most countries are pursuing their own approach to Fintech. Some have adopted new tools, such as sandboxes, incubators, accelerators and innovation hubs. These allow for experimentation, innovation and information exchange while permitting an assessment of how to better manage the associated risks.

Authorities are fully aware that an active Fintech ecosystem that is able to produce innovative technological solutions can be instrumental for banks to improve efficiency and the quality of their services; a friendly regulatory framework is necessary but not sufficient. The development of a Fintech ecosystem also depends on many conditions, including the availability of funding (e.g. venture capital) and human resources with adequate educational or professional background and specific skills. More broadly, it requires an economic environment that is conducive to entrepreneurship.

Some time ago the Bank of Italy launched a Fintech hub on its website. This was an attempt to adopt a business-friendly stance towards those who are interested in establishing a start-up, opening a new line of activity, etc. We strive to provide rapid feedback and try to solve problems relating to the interpretation of the rules in order to reduce regulatory uncertainty, which is a major deterrent for new businesses. The hub also allows us to gather precious information on this new world teeming with ideas and initiatives.

A new task force on financial innovation has been established within the Directorate General for Banking and Financial Supervision with the aim of better understanding trends and initiatives from the supervisor's perspective. Another objective is to promptly detect all factors of change in order to analyse their effects and risks. Finally, a third goal is to promote harmonization of supervisory practices and to take, whenever possible, appropriate action.

The licencing process affords the Bank of Italy unique insight into Fintech developments. Licencing is when the push for innovation – arising from the market – first meets the need to protect public interest – in the remit of the supervisor. The licencing function represents, in a nutshell, the entry point for innovative projects that might give rise to new financial players or lead to new products and services for customers.

The various Fintech initiatives can generate projects that require a bank licence or, more often, an authorization to operate as payment or e-money institutions. The initiatives usually leverage supporting technologies (e.g. a data management platform or solutions for big data) to offer their clients highly customized products featuring an extremely fast and exclusively web-based working process; a full set of payment services usually comes with these products. The launch of Fintech initiatives through payment or e-money institutions is the most frequent way to enter the financial market. The most common initiatives consist in the creation of a payment institution to support the lending crowdfunding platforms; the payments can be completed using electronic money products.

Major European financial players have also presented some Fintech-related projects. These initiatives reach the Italian market through the passporting procedure and usually stem from a comprehensive reorganization of business models, in some cases triggered by Brexit.

Conclusions

As seen so far, Fintech offers a wide range of possibilities, which national authorities should try to support. Although the benefits of technological change may require time to fully materialize, innovation contributes to the decline in costs, the reduction in information asymmetry, the increase in efficiency and competition, and wider access to financial services. However, national authorities are concerned about the potential risks which may arise for the financial system and for customers, as well as for the economy at large: the challenge ahead is, therefore, to settle the embedded trade-off between the benefits and the risks that impinge on financial stability, sound and prudent management, and consumer protection.

In conclusion, let me wish to all of you attending the Summer School, and to your professors, every success for your week here and for your future endeavours. No one has ever predicted how technology would evolve, and this is more true today than ever. But I think that in any field, and in the financial sector too, the quality of the changes derives from the ability of each and every one of us to contribute to these developments with the awareness that the future has already begun.

Designed by the Printing and Publishing Division of the Bank of Italy