INSTITUTE FOR FINANCIAL
INTEGRITY AND SUSTAINABILITY

SPEECH

The digital transformation of the European banking sector: the supervisor's perspective

Speech by Pentti Hakkarainen, Member of the Supervisory Board of the ECB, at the Institute for Financial Integrity and Sustainability
13 January 2022

Digital transformation is a must for banks. Changing customer demands together with pressure to reduce costs and increase efficiency are leaving banks with no option but to use modern technology.

In my remarks today, I will explain what I consider to be the most relevant technological changes in the banking sector and the advantages for banks and their customers alike.

But these changes will also bring new risks. Banks need sustainable business models to be ready for this. So today I would also like to outline the risks I see from the supervisory perspective and the role supervisors can play in mitigating those risks.

Overall, I am optimistic about these technological changes. In particular, I see benefits for customers and the prospect of a more competitive banking sector, which should encourage banks to pursue useful forms of innovation.

The digital transformation and the platform economy

The coronavirus (COVID-19) pandemic had a significant impact on the digital transformation, creating a direct need for banks to communicate with their customers through digital channels, such as platforms and apps, while social distancing was the norm. The number of digital users has increased by 23% since the start of the pandemic.[1]

But these technological developments cannot be seen as something new. Bank customers have been moving from traditional branch-based banking to online and mobile alternatives for some decades now.[2]

Customers have become more familiar with the use of products online. This has opened up the market to new entrants – such as fintech firms and big tech platforms – which are able to develop attractive and easy-to-use customer interfaces for their services. As a result, services are offered in an efficient manner to customers, enabling the unbundling of financial services and offering customers a wider range of choices creating more customer involvement in the process.

The efficiency gained from providing solely online services can be seen in the example of the Chinese entity WeBank. Launched in 2014, it now serves more than 200 million individual customers and 1.2 million small and medium-sized enterprises, yet it doesn't have a single branch and employs only 2,000 people. Its fixed costs are therefore lower, while its income from customers is one-thirtieth of that of banks' average and it can reach a return on equity over 30%. Another example is the Brazilian entity Nubank, which provides credit cards and personal loans to 50 million customers. Most of these customers couldn't get a loan from traditional banks owing to their lack of credit history. But Nubank uses data about customer behaviour and its own algorithms to perform its assessment.[3]

Big tech firms like Amazon and Google were also able to start offering financial services. They did so quickly using their networks, customer data and available technology to focus on specific financial services attached to their other services. Traditionally, banks have been gatekeepers of relevant customer data, in particular the data needed to assess customer creditworthiness. But big tech firms can also increasingly perform a similar assessment leveraging on their customer data, therefore it seems that banks' traditional gatekeeper role is being challenged.

Convenience and, above all, user-friendliness seem to be behind the success of these new market players. In other words, customers appreciate being able to access all their financial services online or via mobile devices. And the simpler the service is to use, the better. In addition, customers can choose from more tailor-made options, including non-financial services, that meet their specific needs. These options are based on the extensive data that providers collect about their customers' daily behaviour.

As the example of Nubank shows, using customer data and analytics enables providers to offer services to customers that don't have a strong credit history, which leads to greater financial inclusion. Other initiatives, such as Apple Pay, also help to increase the availability of financial services. The impact of this can be significant, especially in emerging markets.

Another factor contributing to user-friendliness is the new layer we are seeing between banks and their customers. For example, some platforms enable customers to compare offers from several banks and then choose the best option. Banks find themselves obliged to allow the use of these platforms as they attract more customers, while opting out could mean that the banks lose customers. But it is the platform that collects the customer data and not the bank, so this development may lead to banks becoming “factories” of services and products which are sold to customers through platforms or apps.

That being said, offering technology-based, user-friendly services is no guarantee that the provider will be immediately profitable. The German entity N26 is an example of a fintech firm that has not yet succeeded: despite its 7 million customers across 24 countries, it has had to stop offering its services in the United States and the United Kingdom. However, its estimated high market value shows expectations of future profitability.

Risks add opportunities for banks?

New technological developments are exerting competitive pressure on banks. Banks will need to react to the changes in their customers behaviour, demanding more efficient and convenient online services.

There are also new risks that come with technological developments. Using technology more widely and involving third parties more heavily, for example through outsourcing and cloud computing, will make banks more dependent on the availability of IT services and more vulnerable to cyber risk.

That being said, these risks are not entirely new territory for banks, as banking supervisors have required them to mitigate all risks, including those related to technological innovation.

And banks do have extensive expertise in regulation and compliance, having already passed the key regulatory hurdles that new entrants are faced with. In addition, many fintech firms and big tech platforms offer their financial services in close collaboration with banks.[4] In fact, it is not yet clear whether or not big tech firms would like to enter the banking market themselves, with all the requirements this would entail.

Overall, banks are aware of the need to adapt to digital transformation. In my current role, I have seen them recognise the need to innovate and make investments over the years, which has resulted in more online services and apps that are used by many customers.

The COVID-19 pandemic has to some extent shown that banks’ digital investments have delivered – at least in terms of ensuring operational resilience. Banks had to deal with major challenges and their IT infrastructures proved to be up to the task – service continuity was smoothly and securely maintained. Most banks are now accelerating their technological innovation.[5]

So banks have not lost out – they are well trusted and customer loyalty is still strong. And some failures with new providers, such as Wirecard, may mean customers remain suspicious and wary of switching to new service providers.

The role of the supervisor

Digitalisation is a key element in creating a future-proof business model. Banks that are not following this development or lagging behind may struggle to succeed in this competitive environment.

As supervisors, our main challenge is to ensure that financial stability and prudential soundness are preserved, while at the same time allowing for technological innovation.

One of our supervisory activities involves gathering information on the digitalisation process of supervised banks to ensure that we have a horizontal picture of where banks stand. This information is necessary for us to maintain a continuous dialogue with banks on this topic and to allow us to provide them with guidance.

Another important area of focus in our dialogue with banks will be the external companies' banks are contracting in order to move towards a more digital approach. Banks will need these companies if they are to move forwards and remain competitive in the new digital world. But outsourcing can also create new risks – it can be hard to monitor external systems, for example, and services may become concentrated among just a few providers. We need to be able to clearly see how these risks are mitigated.

Take an example we are regularly confronted with – cloud computing. Cloud computing has become ever more important to banks seeking to develop their IT systems, and this is having a significant impact on how banks structure their business. More and more activities run in the cloud, which is continuously evolving and despite of that it's more economical than banks running their own data system. The appetite to outsource activities to external service providers has increased. Within supervision, we carefully monitor such outsourcing arrangements to ensure that they do not result in banks becoming empty shells or create obstacles to effective supervision.

Importantly, it's not just banks that have work to do. In this new era, supervisors also have to strengthen their supervisory skills and resources to effectively monitor banks' digital transformations. Technological development brings new challenges to traditional supervisory methods. For example, fragmented value chains lead to more diversified access to customer data. In a similar vein, a high degree of customisation of algorithm-based tools may not always allow for supervision via traditional supervisory processes.

Insights from market participants will help us to increase our knowledge and further strengthen our guidance for supervisors on how to assess banks' digitalisation strategies and the risks related to specific use cases. Governance and risk management, IT and security management and data quality management will increasingly require our attention. Amid evolving and diversifying cyber threats, cyber resilience will remain an important topic of supervisory attention. This warrants the prioritisation of IT risk and related dedicated analysis both on and off site.

More specifically in the context of digital platforms, supervisory authorities may not always have sufficient insights about the type of data collected, consent collection from end users or whether digital entities are monetising customer data. Technology can help supervisors here.

We are also working to improve our internal processes, for example by streamlining reporting lines and integrating reporting frameworks through the development of a single data dictionary. I expect this to result in further improvements and increased efficiency in the future. For example, it could allow us to build systems that would give supervisors direct access to banks' data systems, allowing them to simply and efficiently "pull" the relevant data as and when needed.

Finally, regulators are also increasingly aware of the changing times. The digital agenda of the European Commission includes new regulatory proposals, such as the Digital Operational Resilience Act (DORA) and the Regulation on Markets in Crypto-assets (MiCA). And on the front of cyber-testing, TIBER-EU sets a new framework and international fora such as the Financial Stability Board and the G7 are increasingly discussing issues related to digitalisation.

It is encouraging that legislators are taking steps to create harmonised European approaches to ensuring that new ways of delivering services are adequately regulated and supervised. We will contribute to these regulatory and legislative debates as much as we can.

Conclusion

Let me now conclude. Today I have spoken about the advantages and risks of technological changes in the banking sector and the role of the supervisor and regulators.

I'm pleased to see this digital transformation taking place, as it will give banks the opportunity to provide more efficient and tailor-made services and products to their customers.

The competition from new market entrants and customers' needs will encourage banks to continue investing in further digital progress. It is too early to tell whose efforts will be enough, – the market will decide this over time.

1. McKinsey Digital (2020), "Europe's digital migration during COVID-19: Getting past the broad trends and averages", 24 July.
2. Hakkarainen, P. (2018), "The digitalisation of banking – supervisory implications", speech at the Lisbon Research Centre on Regulation and Supervision of the Financial Sector Conference, Lisbon, 6 June.
3. McKinsey (2021), "McKinsey's Global Banking Annual Review", 1 December.
4. Bank for International Settlements (2021), "Fintech and the digital transformation of financial services: implications for market structure and public policy", *BIS Papers*, No 117, 13 July.
5. Hakkarainen, P. (2021), op. cit.