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The Future Of Banking: Will Retail Banks Trip Over Tech Disruption?

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(***Editor's Note:*** *This article is part of a series of commentaries on retail banking sectors, illustrating how technology disruption forms part of S&P Global Ratings' analysis of banks.)*

Key Takeaways

- In our view, four technologies may alter global retail banking sectors over the next few years: mobile banking, cloud computing, artificial intelligence, and blockchain.
- Although we believe customer preference will be the main catalyst for change, banks' ability to respond will depend on their digital readiness.
- We believe regulation and governments' willingness to lay the groundwork for banking innovation can promote more rapid change.
- The authorities would also need to act swiftly to protect banking systems from disruption that may reduce the quality of banking services or result in weaker, more vulnerable banking systems.

Digitalization is already transforming retail banking. In our view, the opportunities and threats for banks from tech disruption relate to the state of technology, regulation, the banking industry's readiness, and customer preferences. We already reflect the potential impact of tech disruption in our Banking Industry Country Risk Assessments (BICRAs) and, subsequently, in our ratings on the respective banks. As such, the content of this article does not signal a change to our methodologies for BICRAs or our bank ratings.

Here, we illustrate how we assess tech disruption in retail banking sectors, as part of our BICRA analysis, using the banking industries of China, France, German, and Sweden as case studies. We believe a comparison by country provides greater insights into the related aspects of tech disruption in these four markets, which, in our view, are in very different states of technological development. Generally, however, banks' disclosure on investments in digital transformation and IT varies widely, which complicates the comparisons. Alongside this article, we've published separate reports on each country, and may publish additional reports in the future.

There's No Turning Back

We believe today's traditional banks have no other option than to digitize their business models. If they execute that well, they can better defend and potentially expand their franchises, and possibly offer new products or services. If not, their market positions and profitability could shrink. Digital solutions will not only allow banks to attract more clients and open up new revenue channels, but also become more efficient, all keys to succeeding in tomorrow's digital environment. Such considerations form part of our assessment of banks' business positions.

In our view, the increased transparency and further commoditization of retail banking services will likely reduce banks' traditional revenue potential by more than 20%, with more servicers competing for the same client pool. We think revenues might be even more at risk in markets with high-margin consumers, where mortgage lending is being commoditized faster. This situation represents a challenge for banks' business models, since retail banking generates on average about 50% of total banking revenues.

What's more, technology is a leveler. We believe the barriers to entering the banking market have reduced materially and are structurally altering the competitive landscape. The cost of launching a digital retail banking product for a fintech company is now marginal compared with that for a traditional bank operating from a brick-and-mortar branch network. It is against this backdrop that we carried out our tech disruption survey to show where banking systems stand with respect to four broad areas: mobile banking, cloud computing, artificial intelligence, and blockchain.

Change Has Already Begun

Traditional banks are already bracing themselves for disruption. According to KPMG, 73% of the $100 billion poured into fintech investments over 2012-2017 were for innovation in banking services for retail and small and midsize enterprise (SME) clients. Fintech and Big Tech companies have already spotted the weaknesses of traditional banks, many handicapped by complex legacy systems, limited capacity to invest, and low customer confidence. On the other hand, some tech players are using their readily available know-how and material budgets to enter the financial services market.

Although the environment for banking systems varies across the globe, we believe banks will increasingly adopt new technologies, and all will eventually go digital. In our view, new technologies will enable currently unbanked or underbanked individuals and SMEs to better access banking services, particularly in emerging markets. This trend is already visible in China and many developing economies, where smartphones are spurring greater financial inclusion, opening up access routes for bank service providers, and for society as a whole by serving residents that previously had no access to banking services. At the same time, we expect banks in Europe and North America to first seek to reduce costs and only then increasingly invest in digital banking solutions to create additional revenue streams.

Technologies At The Forefront

We believe the availability and fast development of technology will lead to a structural shift in the banking industry. We expect four technology types will gain in importance and represent important considerations in determining the winners and losers in retail banking over the next few years.

Mobile banking

Fully digitized and convenient ways to offer and execute services and products will enable banks to onboard and retain existing clients. Simultaneously, banking will be more easily available to the unbanked or underbanked population and to SMEs, facilitating greater financial inclusion. The comparably lower incremental investment versus running a large branch network will further lower barriers to entry for new competitors.

Cloud computing

This is a prerequisite for the storage and processing of vast amounts of information to improve capacity for innovative products. Cloud computing provides the power needed to commoditize unstructured data, allows banks the flexibility to scale their IT infrastructure up or down, and reinforces the resilience of cybersecurity because of simpler update solutions.

Artificial intelligence (AI), machine learning, automation, and robotics

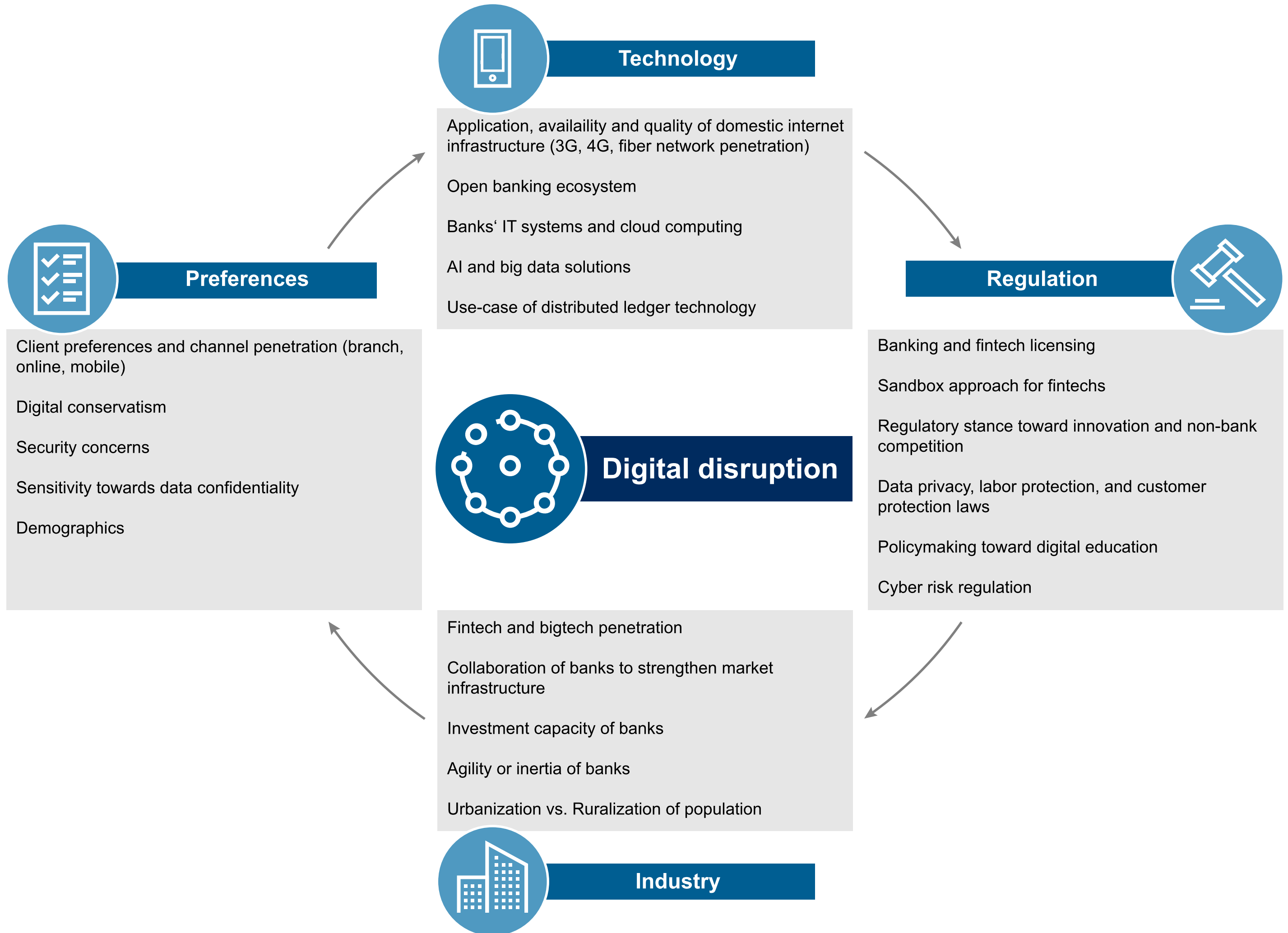
Thanks to their information-rich client data, banks, with the help of AI and related technology, will be better able to offer tailored services. We believe this technology will allow banks to expand revenues by better understanding client behavior and preferences. At the same time, AI-based solutions will enable banks to establish state-of-the-art "know-your-client" processes and compliance systems to better prevent reputation and financial risks stemming from criminal activity.

Distributed ledger technologies and blockchain

We expect this technology to allow banks to transact business more efficiently and securely. Although we still believe current use cases to be marginal, blockchain application might result in a leaner way to execute structured transactions. Banking regulation will also need to adapt, and the digital literacy of potential product users must improve for banks to fully leverage blockchain solutions.

Four Facets Of Tech Disruption For Retail Banks

To determine the risk of tech disruption in each banking market, we assess the current state of technology, regulation, industry, and preferences (see chart 1), in what we call our TRIP analysis. Our aim is to explain how we expect the banking industry in each country to evolve. In our TRIP analysis, we focus on domestic operations since retail banking is usually dominated by domestic banks. Nevertheless, we expect that technology will enable banking groups to act more globally by exporting established and tested domestic platforms.



Source: S&P Global Ratings.
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We score each TRIP factor on a scale from '1' (very low) to '5' (very high). Some categories may represent an elevated risk in the respective market. The subfactors in chart 1 are not an exhaustive list, but rather a starting point for what we believe to be the chief drivers of each factor.

In assessing the four factors for the banking industry, we look at the following:

Technology: how advanced the banks' overall technological capabilities are and how supportive the country's technological infrastructure is. The more advanced the banking systems technological capabilities, the less risk we see of disruption. On the other hand, if banks lag behind in technological developments, nonbank competitors may take over profitable parts of their business through state-of-the-art solutions.

Regulation: to what extent banking regulation and national laws protect incumbents' market positions or foster innovative competition. Protective and stringent regulation acts as a barrier to entry for nonbank players and reduces the risk of market disruption, in our opinion. Regulatory easing, such as sandbox approaches, can lead to higher innovation potential for the retail banking industry. The impact of the legal framework and data privacy legislation is not as evident, but it could hamper tech companies' ability to fully use their existing customer bases and analytical capabilities.

Industry: to what extent the banking system's existing structure, profitability, and strategy support banks' ability to invest in digitalization and adjust to a different and more challenging environment. We also consider cooperation between banks and fintechs, as well as between competing banks, which can speed up technological advancements and make it more difficult for new entrants to gain a foothold, thanks to network effects.

Preferences: how likely customers are to embrace new technologies and possibly switch to nonbank competitors; the greater the preference for emerging technologies, the higher the risk of clients migrating to players with the most convenient solutions. A higher preference for traditional banking leads to a lower risk of disruption, in our opinion, because banks can rely on their established market presence. High risk aversion and data privacy concerns also reduce disruption risk, and vice versa.

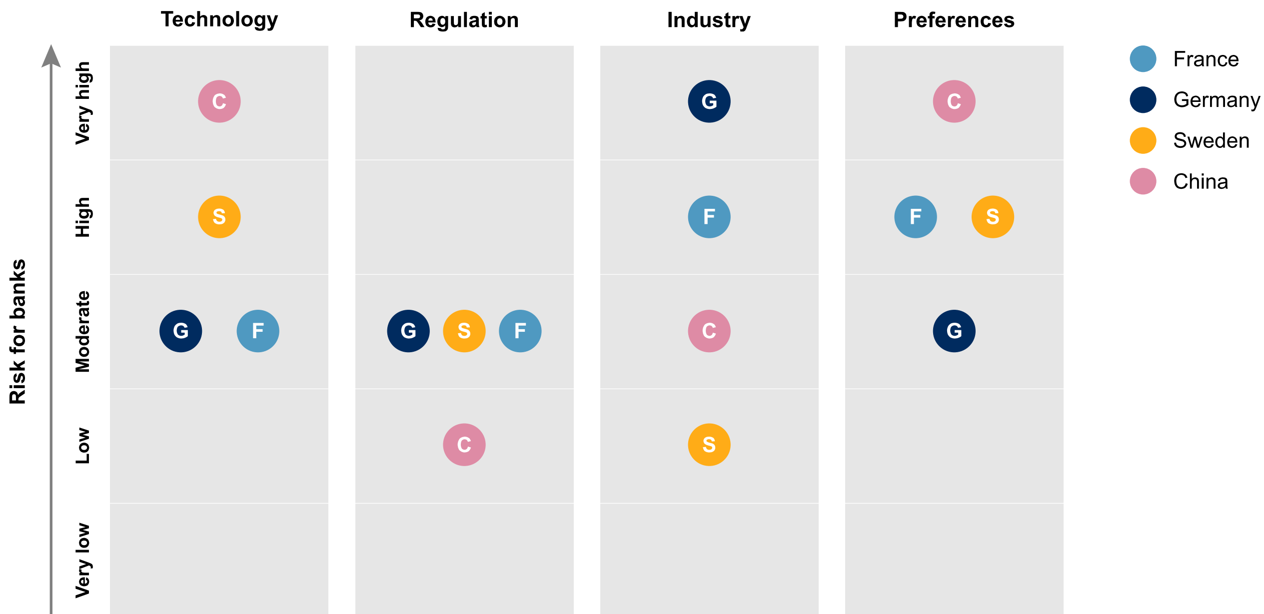
We recognize that the factors may be interrelated. For example, new technology might call for new regulation. However, we analyze each factor and their subfactors in isolation, to avoid overlapping scores.

Our TRIP Analysis Isn't Static

We expect the bar will rise quickly for what constitutes digital readiness, and we may therefore have to change our analytical approach. Many established banks' current focus on more efficient end-to-end digitalization might soon become a standard, in which case the banks may turn even more toward the user experience to generate additional revenues. We already observe that digital leaders in the banking universe materially invest in this area and are able to solidify or broaden their franchises.

We do not assign an average or overall disruption risk score for each country because we believe that a higher score in one category will not offset a lower one in another. As an illustration, we show the relative disruption risk we see for the respective banking industries in China, France, Germany, and Sweden (see chart 2). For example, we see very high risk for China's domestic banks from technology and from customer preferences. If a bank cannot deliver state-of-the-art technology for highly demanding retail clients, this is a negative factor in our business position assessment. We also regard client preferences as a source of high disruption risk in Sweden and France, but less so in Germany. Despite commonalities across banking systems (for example, similar risk from regulation in Germany, France, and Sweden), there is no one-size-fits-all when it comes to disruption risk. For the detailed TRIP analysis, please read our Tech Disruption surveys for China, France, Germany, and Sweden (see Related Research).

Current Risks For Banks Arising From Digital Disruption (TRIP-Assessment)



*The disruption risk for banks describes our perceived risks that arise from a certain category of factors to a countries' banking industry. The scoring reflects the status quo of disruption risk and is a relative assessment, i.e. risks are ranked in a peer context. There is no explicit quantitative analysis behind the scoring. The assessment is an expert view of S&P Global Ratings and includes analysts' judgement and interactions with banking market participants.
Source: S&P Global Ratings.
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What Our TRIP Analysis Illustrates

We believe that client preferences and new technologies will have the most power to disrupt retail banking markets, despite differences in sensitivities from one market to another. It is becoming critical for banks to prepare themselves for the new world of retail banking, where technological change is accelerating and powerful entrants are looming. While the main rating drivers for our assessment of individual banks will remain the same--business position, capital and earnings, risk position, funding, and liquidity; building on our BICRAs--new opportunities and threats could change our views, positively or negatively, about these components. In particular, this relates to our business position assessment, in light of the potential disruptive force of digitalization.

Meanwhile, Big Tech is likely to continue setting ever higher standards for convenient, 24/7 services independent of country borders, which we see happening in China, and with Apple and Google in mobile payment services. To defend themselves, banks need to use technologies efficiently, building on state-of-the-art IT infrastructure to preserve market share and client proximity.

While banks previously offered mainly in-house products, future market leaders will provide the most convenient banking products embedded in simple platforms, in a bid to prevent clients from switching to more sophisticated or convenient servicers. Therefore, we expect banks to reserve large budgets for user-experience expertise and analysis. Market regulation, legal frameworks, and political actions will remain key to promoting competition and innovation, as well as safeguarding the market against the negative effects of disruption, weakening of service quality or

weaker more sensitive banking markets.

Next Steps: Increased Disclosure And Standard Indicators?

We believe the current level of public disclosure by banks regarding digital progress does not allow for more detailed peer analysis. The disparities are even more pronounced in a cross-country comparison. More positively, we observe that some banks have already started to disclose a set of digital key indicators and some have published presentations solely to report on their digital and technological strategy and progress.

To foster market transparency and comparability, banks' wider publication of standardized performance indicators would help investors assess their exposure to and preparedness for this risk.

Related Research

Tech Disruption In Retail Banking: China's Banks Are Playing Catch-Up To Big Tech, May 14, 2019

Tech Disruption In Retail Banking: France's Universal Banking Model Presents A Risk, May 14, 2019

Tech Disruption In Retail Banking: German Banks Have Little Time For Digital Catch-Up, May 14, 2019

Tech Disruption In Retail Banking: Swedish Consumers Dig Digital--And Banks Deliver, May 14, 2019

This report does not constitute a rating action.

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