Digital Ecosystems – Possible Solutions in Times of VUCA

Digital banking ecosystems: moving forward open finance and beyond

Ladies and Gentlemen, a very good afternoon.

I would like to start by thanking Dr. Nader Maleki and the International Bankers Forum for the kind invitation to participate in today's event, about "The future of finance in times of great turbulences". And secondly, I would like to state that although I preside to the Portuguese Banking Association, what I will be saying during this session is of my own responsibility and do not represent the views of the Association or of its associates.

[SLIDE 2 - Shocks]

I am not sure if the times they are changing, as the song goes, but the world around us seems to have gotten too unsettled and challenging than we had grown used to, especially those of us that have been young for a longer time, as it is my case. A rapid succession of unexpected world shocks like the pandemic, the war in Ukraine and the rekindling of inflation have suddenly turned our lives into a foggy unease, upsetting the comfortable modus vivendi to which we had become accustomed over some three decades of peaceful development.

But truly, before these disrupting shocks, our ways of life were already increasingly restless in face of a faster and faster spin of the world around us, brought about by technological evolution and globalization and leaving less and less time for changes to set in or making them obsolete quicker that our minds would need to process and absorb them.

Hence, the world becoming perceived as increasingly volatile, complex, uncertain and ambiguous, as the fashionable acronym suggests, requiring our reaction functions to adjust to these new conditions so as to keep up with the rapid and disturbing changes.

As the world itself is too large and convoluted a problem to dealt with, I will confine my participation to a less ambitious undertaking, focusing just on the challenges posed by, and to, Digital Banking Ecosystems, especially in Europe.

[SLIDE 3 – Banking Ecosystem facing Fintechs and BigTechs]

The traditional Banking Ecosystem has seen its equilibrium being challenged by the entry of new species – generally dubbed as *fintechs* –, but above all by the threat of the whole new ecosystem of the large digital platforms – hence labelled as *Bigtech*. The first challenge will lead to some repositioning and reformatting of the pieces, similar to other ecosystems when a new specie gets in. Banks will incorporate more and more digital technologies into their workings, some *fintechs* may end up prevailing in some niches of activity and the two sides, banks and *fintechs*, will end-up cooperating and/or integrating. The second challenge is more serious as it can turn into a predatory threat to the entire ecosystem.

In Europe, the challenge is particularly acute, as the Continent seems to be lagging behind on the technological front, especially with regard to the world of large digital platforms, which are dominated by the United States and China. Thus, in addition to the common challenges faced by its banking ecosystem, as mentioned above, Europe as a whole also risks losing strategic control over it.

[SLIDE 4 – McKinsey causes for European fragility]

A recent report from the McKinsey Global Institute assigned this technology gap, and its inherent competitive fragility, to four causes: i) market fragmentation and lack of economic scale; ii) smaller and less established technology ecosystems firms; iii) less developed risk-capital and scale-up funding; and iv) complex regulatory environment, that could be less supportive of innovation.

Market fragmentation and lack of scale are particularly important because, notwithstanding the mantra of a single European market, what really exists is a collection of fragmented national markets, each one lacking dimension to allow the necessary scale-up of domestic firms in order to become able to compete in larger world markets at marginal costs, as American and Chinese firms do in Europe. The very existence of national competition authorities, overzealous in protecting their domestic turf as the definition of relevant markets to assess the expansion of national firms is, in itself, a contradiction in terms with the said mantra of a European single market.

This fragmentation, besides its inherent shortcomings, also helps to largely explain the smallness of firms and the limitations apparent in technological ecosystems and in risk-capital. But the regulatory environment, complex and addicted to disregarding rational cost-benefit analyses, has been a hindrance to innovation and competitiveness and bears a high degree of responsibility for the lagging position that Europe shows vis a vis the United States and China in advanced technological developments. As a simple example, Europe lacks – and seems to be lacking for a long time – a retail payment instrument susceptible of worldwide acceptance at par with those already in place by those two countries, and largely used in Europe.

Under existing regulatory frameworks and radical views on competition, I would risk to say that a project like Airbus – that placed Europe almost at par with the United States in the aeronautical industry – would not be possible today.

[SLIDE 5 – Digital Banking Ecosystem]

But descending to the more terrestrial grounds of the banking ecosystem and its more immediate challenges, it is fair to say that these arise from the increasing digitalization of processes and channels to address and be addressed by consumers, the change in consumer behavior and expectations, accelerated by the pandemic, the growing competitive landscape mentioned before, the emerging technologies such as big data, artificial intelligence and distributed ledger technology.

Banks are aware of the implications raised by these challenges and seem to be responding accordingly. But – and I am sorry if I insist on the point – they are very much constrained by the heavy regulatory grip imposed on their activity, making it more bureaucratic much more costly and less profitable. Which triggers a kind of a conundrum: to succeed, banks need to innovate and respond to the new technological challenges; to do so, they need to attract capital, which in turn requires the activity to be profitable and generate returns above the cost of capital; but heavy regulation raises production costs and limits the search for returns, undermining profitability. At the same time, the main challengers, free of such regulatory fetters, become more easily attractive to equity investors and therefore better equipped to storm the established ecosystem.

[SLIDE 6 – Takeaways]

What is then necessary to succeed in these times of VUCA is a more levelled playing field for all competitors – same activity, same rules and same supervision – so that each player can succeed or fail based on its own merits and not on the label assigned to it; and that regulators get used to constrain their imagination by submitting ideas to a careful cost-benefit analysis, so as to make clear that the social benefits intended by new regulations clearly outweigh the social costs imposed on the system.

Banks play a very relevant social role, and this relevance was well proved, once more, during the pandemic crisis when banks were at the forefront of alleviating the social and economic costs of the crisis. If allowed, they will continue to be so, regardless of the complexities and uncertainties that surround the times we live in. After all, their activity remains crucial for social development.

Thank you.

Vítor Bento
24/10/2022