COVID-19 crisis to alter banks' business models

Looking ahead, the banking sector is likely to need a deep restructuring, according to Xavier Vives and coauthors of The Bank Business Model in the Post-COVID-19 World, the second report in the IESE-CEPR series on the future of banking.



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- **Although banks have performed robustly in the immediate wake of the pandemic, impending large-scale bankruptcies -- coupled with persistently**

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low interest rates, regulatory changes and new competition -- are likely to cause fallout for banks.

- **The result may leave the sector with a few dominant platforms, including transformed incumbents and Big Tech firms, while medium-sized banks are likely to suffer disproportionately.**
- **The banking sector will need a deep restructuring, with regulators seeking to facilitate competition and innovation, while protecting financial stability.**

The COVID-19 health crisis will stretch the limits of central bank intervention and test the incomplete Banking Union in the euro area. These are two key findings of *The Bank Business Model in the Post-COVID-19 World*, the second report in "The Future of Banking" series from IESE and the Centre for Economic Policy Research (CEPR). The June 2020 report examines the mounting and unprecedented challenges currently facing the sector, as well as the competitive responses of both veteran and new players.

The report notes that while banks have performed robustly in the immediate wake of the pandemic, mostly thanks to overhauls and increased liquidity stemming from the 2008 financial crisis, they face a potential fallout from impending large-scale household and corporate bankruptcies.

Banks also face significant pre-existing threats such as persistently low interest rates; regulatory changes; and growing competition from the shadow banks and digital upstarts that were challenging traditional business models well before the pandemic and its attendant economic devastation.

An altered digital future

A central finding of the report is that the pandemic will accelerate these pre-crisis tendencies of the banking sector, as digitalization advances at a more rapid rate, interest rates remain low and growth stalls. The report also analyzes the policy and regulatory issues associated with the digital world, and suggests future policy options for reform.

Its key findings include:

- In the short term, banks may enjoy a revitalization of relationship lending as they channel funds to customers over the crisis and are protected by the safety net and access to deposit financing.

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- While banks may be granted temporary regulatory and supervisory relief, digitalization will receive a large impetus, with new entrants challenging banks.
- Digitalization will further reduce barriers to entry and exit for the financial services market, but its long-term impact will depend on the market structure that prevails. The result may be that a few dominant platforms, which include both transformed incumbents and Big Tech firms, control the access to a fragmented customer base.
- Medium-sized banks will suffer since they cannot manage the cost efficiencies and IT investment crucial in the new environment. Consolidation could be an escape route for stressed banks but, in the post-COVID-19 world, political obstacles to cross-border mergers may resurface as states become more protective of their national banking systems.
- Regulators must adapt to digital disruption by balancing their roles as facilitators of competition and innovation and as protectors of financial stability. This means they must coordinate prudential regulation and competition policy with data policies, navigating complex trade-offs.

Finally, the current crisis will undoubtedly test the resilience of the financial system and the regulatory reforms implemented after the global financial crisis of 2007-2009, which were examined in the first report of the Banking Initiative.

The report was prepared by Xavier Vives (Professor of Economics and Finance, IESE), Elena Carletti (Professor of Finance, Bocconi University), Stijn Claessens (Head of Financial Stability Policy, Bank for International Settlements) and Antonio Fatás (Professor of Economics, INSEAD Business School).

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