
Fintech and the Digital Transformation of Financial Services: Implications for Market Structure and Public Policy (Market Structure Note) by Erik Feyen, Jon Frost, Leonardo Gambacorta, Harish Natarajan, and Matthew Saal

Financial intermediaries, such as banks and insurance companies, act as the middleman, linking together participants in financial transactions. Economic frictions in the form of information asymmetries and economic forces, such as economies of scale and scope, give rise to financial intermediaries and shape financial markets. While technological advances are not new to finance, digital innovation has brought major improvements in connectivity of systems, in computing power and cost, and in newly created and usable data. This digital innovation is shaking up financial intermediaries and the markets in which they operate.

Digital improvements have alleviated transaction costs and given rise to new business models and new entrants. As technology has increased information exchange and reduced transaction costs, the production of financial services could be disaggregated. Specialized players have unbundled financial services, allowing consumers to find and assemble their preferred suites of products.

Digital technologies are reshaping payments, lending, insurance, and wealth management—a process that the COVID 19 pandemic has accelerated. While this is making financial services in many economies more diverse, competitive, efficient, and inclusive, it may also increase concentration in markets. Economies of scale and scope, and network effects are present in many aspects of financial services production, including customer acquisition, funding, compliance activities, data and capital (including trust capital). Despite advances in technology, the costs of consumer search and assembly remain significant. These forces encourage re-bundling, and confer advantages to large multi-product providers, including technology (big tech) firms expanding into financial services from adjacent markets.

Moreover, new risks may arise to a range of key public policy goals. This paper draws on the underlying economics of financial services and their industrial organization to examine—with recent empirical evidence—the implications of digital innovation for market structure and attendant policies, including financial and competition regulation.

The organizing framework for the discussion is built around how economic frictions and economic forces, mentioned above, are driving market changes. For example, mobile phone use has surged globally; social and economic activity has shifted online—often to platform-based businesses—and new technologies like cloud computing have been widely adopted.

These improvements have alleviated frictions, blurred firm and industry boundaries, and given rise to new business models. New and often smaller and more specialized financial technology (fintech) players have unbundled services (see definitions). Economies of scale and network effects are strong in digital platforms and cloud computing. These scale effects, alongside economies of scope, encourage re-bundling, and allow large technology (big tech) firms and other new players to deepen inroads into core financial product markets. Available evidence shows that big-tech firms are rapidly expanding their footprint in finance and can use Big Data in ways that reduce the need for collateral. Meanwhile, incumbent financial institutions have adapted by adopting new technologies and by disaggregating their production of financial services to improve efficiency.

Digital innovation could drive a range of industrial organization outcomes. On the one hand, digital technology enables niche providers to reach a target customer base and be economically viable. On the other, customer acquisition, funding, “assembly,” and switching costs tend to favour larger providers. One possibility is a “barbell” shaped market, composed of a few large players and many niche players. The large, multi-product players could include traditional financial institutions, fintech and big tech firms—both incumbents and new entrants. Small players may include product, geographic or sector-focused fintech firms and incumbents.

While a “barbell” is not the only potential outcome, it is a central case, given the economic forces at work. It is a potential steady-state market structure as some participants leverage scale economies and network effects to grow larger, while innovation continues to result in new entrants. Market forces will push players to either hyper-focus or to aim for the large, multi-product type of service offering. However, atomization—the reduction of services to their most basic parts—may continue and re-aggregation could stall, leading to a market of more small players. Then again, limits on entry could result in a completely different market configuration. It’s difficult to predict.

This analysis gives rise to important policy issues regarding competition, regulatory perimeters, and ensuring a level playing field. Concentration risks may increase in the provision of financial services to end-users, and in the provision of infrastructure to financial institutions. Market structures that concentrate data and supercharge network effects could reduce intermediation costs and broaden inclusion. In many markets, however, the resulting market power might be detrimental. Competition regulators will have to strike a balance appropriate to the needs of their markets, since different societies will attach different preferences to market structure outcomes.

At the same time, financial regulatory authorities are working to manage policy trade-offs between stability and integrity, competition and efficiency, and consumer protection and privacy. The barbell outcome, for example, could present challenges in terms of stability with respect to both large and small payers. Widespread access to data raises privacy concerns. Regulators need to balance the innovation and efficiency brought by new entrants with the potential challenges for oversight, enforcement, and consumer protection. Emerging policy approaches—such as new anti-trust rules for the digital era, data mobility requirements, and data protection laws—may help mitigate the policy trade-offs. Yet the responsibility for these changes generally lies with different public authorities, and with legislatures.

Financial services are undergoing a profound transformation. To navigate this new territory effectively, and to balance the necessary policy goals, authorities will need to collaborate. This will need to occur both domestically—with cooperation between central banks, financial sector regulators, other industry regulators, and competition and data protection authorities—and across borders. Such collaboration can help to ensure regulatory consistency and peer learning within and between countries, and ultimately better development outcomes for the country.