Analysis

Nordic banks go digital

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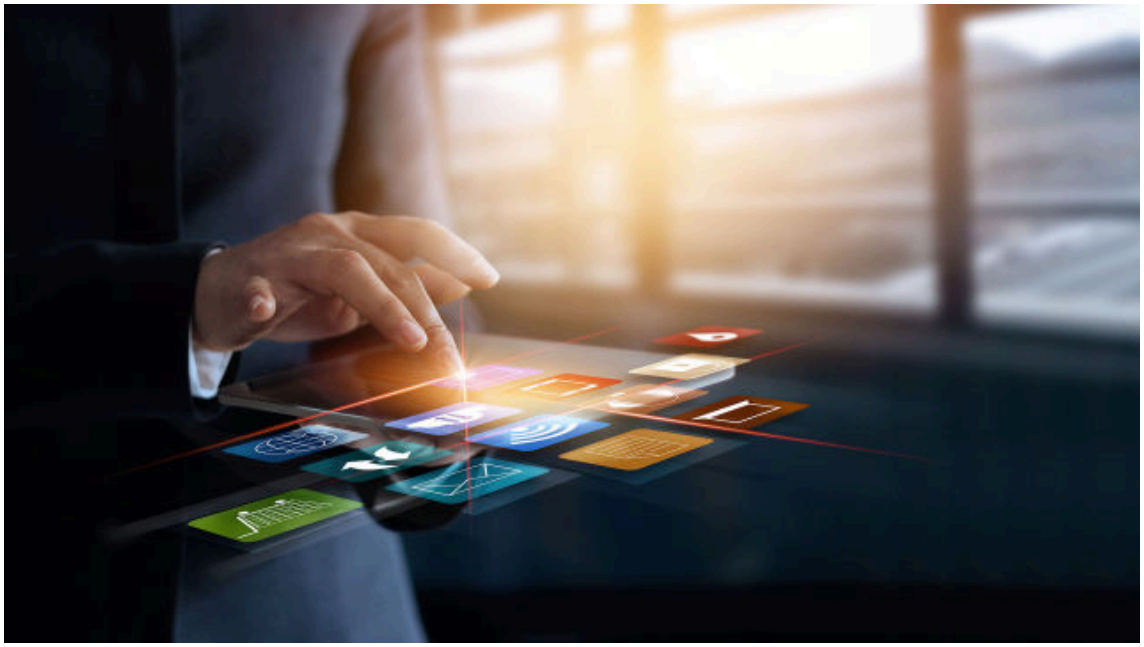


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The Nordic countries are the most digital societies in Europe, which is also reflected in past and future investment within the Nordic banking sector in digital business models. Keeping up with digitalisation helps these banks respond to the competition posed by new FinTech actors. Elsewhere in Europe, the banking sector as a whole is not as digitally advanced. In the longer term, the lack of a digital strategy may weaken individual banks' position in the provision of various financial services. A material shift in this activity from banks and other closely regulated and supervised entities to loosely regulated actors could give rise to new kinds of risks.



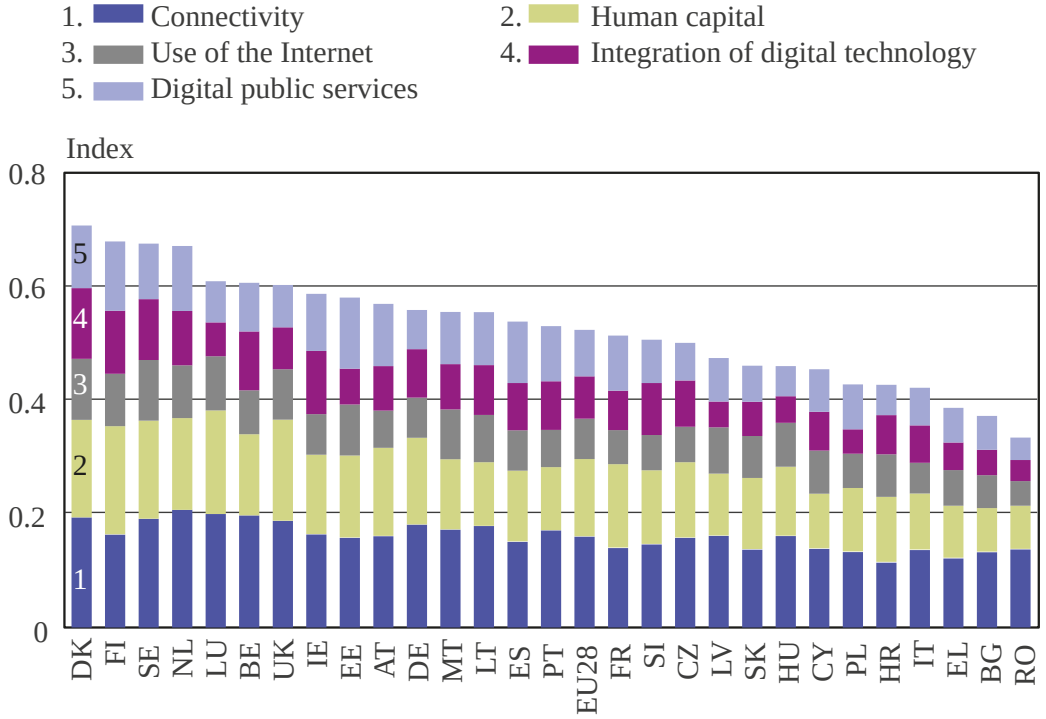
The Nordic countries are digital societies

The Nordic countries lead digitalisation in Europe, measured by a number of indicators: the use of broadband and mobile broadband is widespread (Chart 1), people are already accustomed to handling a variety of matters – such as submitting a tax return form – electronically, and soon nobody will recognise a paper-based share certificate. In many other European countries, digital services are not as self-evident. Instead, matters are handled face-to-face and forms are completed by pen on paper. The more progress countries make with digitalisation, the easier it is to integrate digital financial services as part of other services.

The Digital Economy and Society Index (DESI) published by the European Commission (Chart 2) shows that the gap between the most and least digital countries in Europe is still large, even though it has slightly narrowed in recent years.[1] For instance, over 85% of the population in the Nordic countries use the Internet daily or almost daily, compared with slightly over 70% in the EU on average. In Bulgaria, Croatia and Greece, almost 30% of the population have never used the Internet, as opposed to less than 5% in the Nordic countries. Country-specific differences are further highlighted by the comparison of the number of mobile broadband subscriptions and the use of the Internet via mobile devices. As a rule, the Nordic countries also rank notably above the EU average in terms of digital skills and infrastructure.[2]

Chart 1.

Finland ranks second in the EU on the DESI index for digitalisation

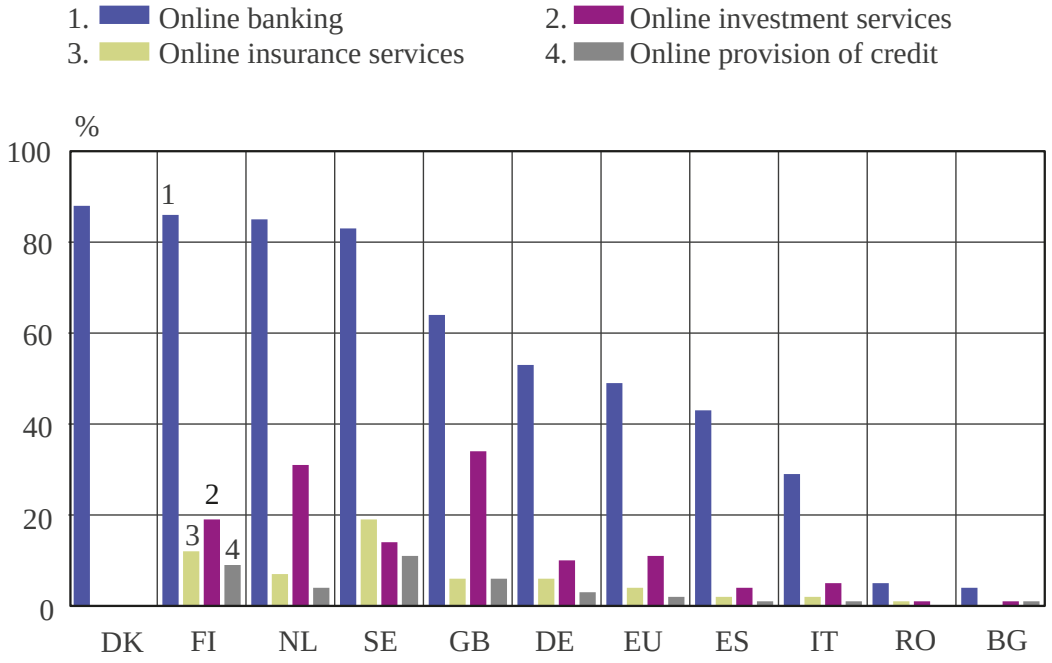


Source: European Commission.

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Chart 2.

Online banking more common in Finland than in many other euro area countries



Source: Eurostat.

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The more people use digital services, the more the digital customer experience guides their expectations regarding other services too. In the financial sector, even with customer consent, third-party access to customer accounts and information and funds in these accounts has been controlled by the traditional actors, i.e. the banks. Customers have not been able to freely choose e.g. the preferred payment method. Instead, they have only been able to select among the methods supported by their bank. Banks' competitive advantage in this area is about to disappear with the revision of the Payment Services Directive (PSD2), if not earlier. Soon banks will no longer be able to decide which authorised service provider customers must choose to initiate payments on their behalf.[3]

Nordic banks are forerunners in digitalisation

Financial services are increasingly shifting online and to mobile devices carried by their owners.

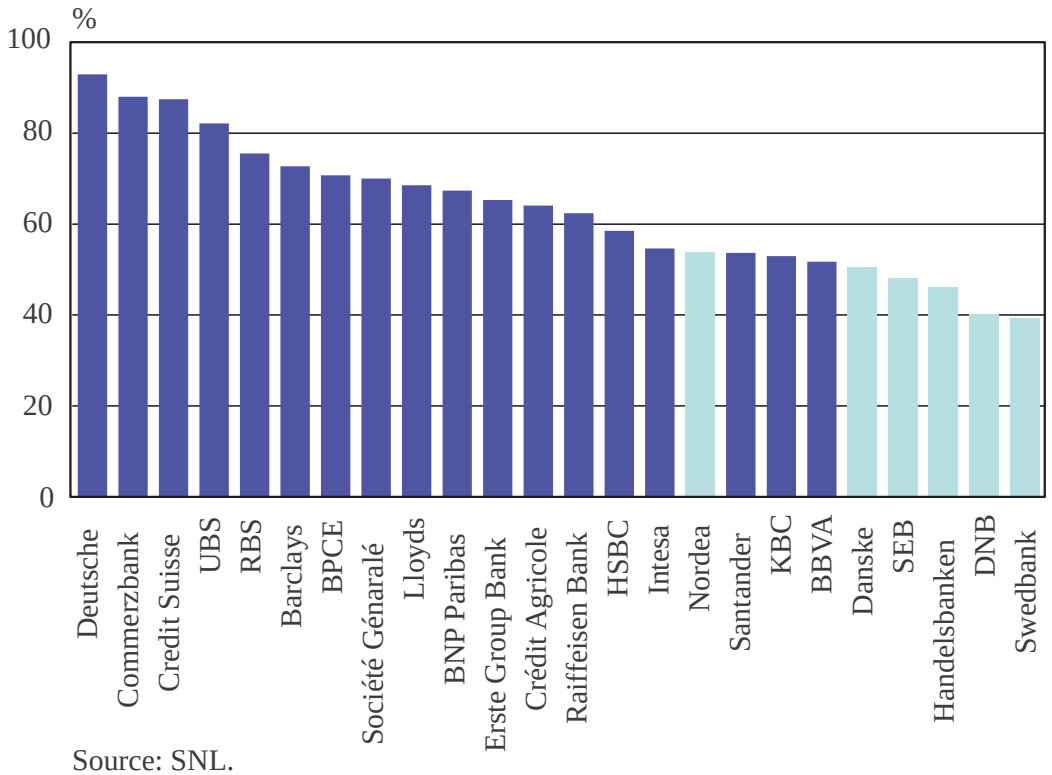
Consumers are no longer benchmarking their expectations about financial services against their customer experiences with other banks, but instead against user experiences gained from other digital services. The pressure for change facing the banking sector comes partly from outside the sector, when new actors (for example FinTech companies) begin to offer financial services. In future, banks will also need to compete more strongly against each other.

Almost all the largest Nordic banks have commenced their own investment in new IT systems and digital business models. The Nordic banking sector has been in a relatively good financial condition since the financial crisis, which is helping to enable these investments.

Chart 3 shows that people in the Nordic countries are highly accustomed to using various online banking services. The declining use of cash in the Nordic region also demonstrates that consumers in these countries are eager to adopt new payment methods.

Chart 3.

Many Nordic banks much more cost-efficient than banks in other countries (cost-to-income ratio)



Source: SNL.

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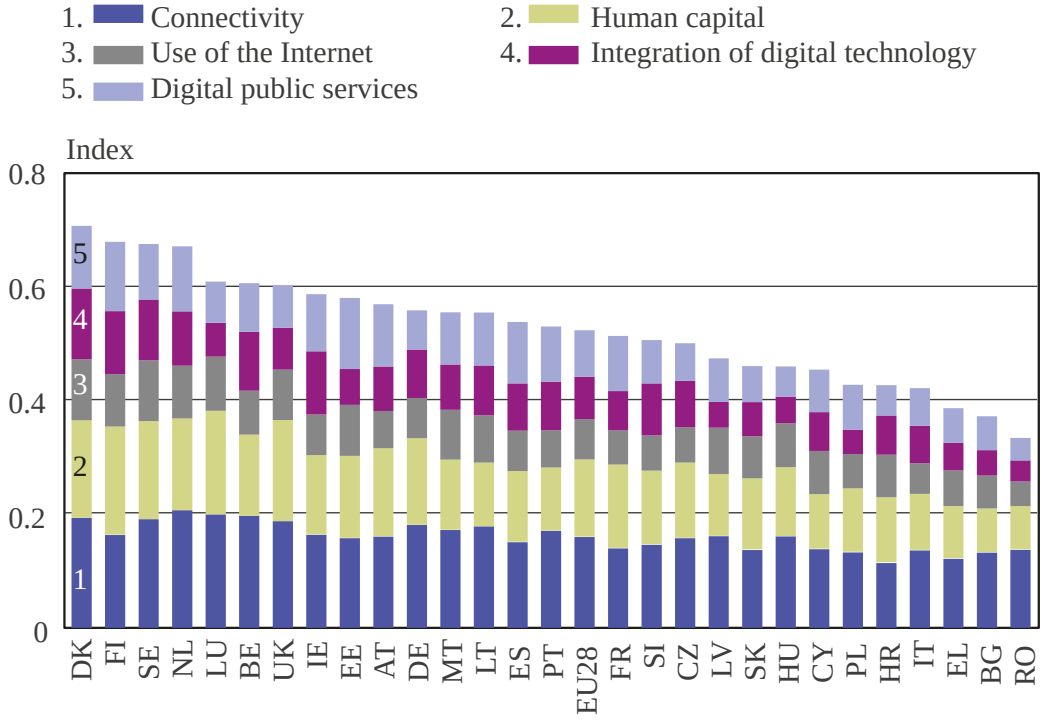
Not only have banks in the Nordic countries invested in digitalisation; the position of new FinTech actors is also better in the Nordic region than in many other countries. Since Nordic consumers have already embraced the mobile lifestyle, it is easier for Nordic FinTech actors to attract new customers. Consequently, there are many FinTech actors in the Nordic countries, and compared with other European countries, the Nordic FinTech sector is larger relative to the size of the economy. However, it should be noted that capital investment in FinTech actors is concentrated in euro terms in only a few advanced companies, and no far-reaching conclusions can therefore be made on the basis of this indicator.[4]

Banks' digital advancement more heterogeneous elsewhere in Europe

Some of the banks in many countries outside the Nordic region, too, strive to remain at the forefront of digitalisation, but some of them have not yet necessarily initiated the fundamental transformation (see Chart 4 on the number of bank branches in different countries).[5] In fact, for many banks, even traditional online banking represents modern technology, and going paperless will only come in the future. This hampers the digital transformation, because moving forward will necessitate substantial financial investment. However, it is difficult to assess whether the digitalisation of banks should proceed in small steps or giant leaps.

Chart 4.

Finland ranks second in the EU on the DESI index for digitalisation



Source: European Commission.

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Relatively weak profitability and problems with non-performing loans, for example, are factors

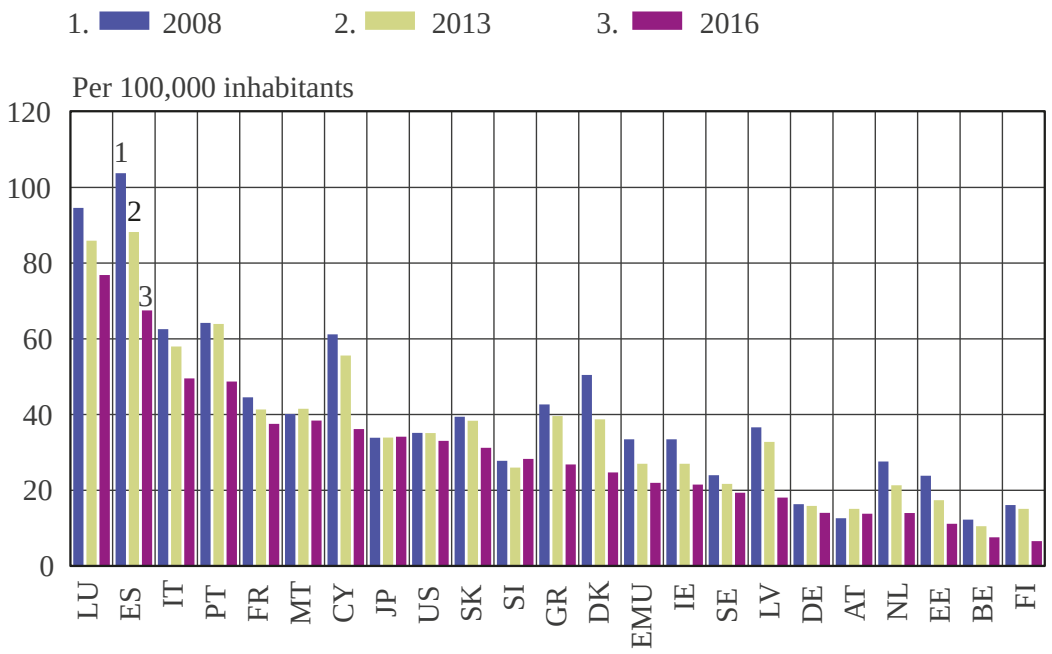
that notably impede digitalisation in many banks outside the Nordic region. If a bank must struggle every day to survive, developing and also implementing a long-term digital strategy is difficult. IT investments and changes in the number of staff and their skills necessitated by digital business models may turn out to be too costly for many banks in the short term, even when these measures could generate substantial cost savings in the longer term. In addition, it is not realistic to assume that the financial sector could become fully digitalised in a country where, for example, the infrastructure is not sufficiently digitalised and users are not accustomed to using digital services. It is also not very likely that an increasingly digital financial sector could force other parts of society to go digital; the causal relationship is more in the opposite direction.[6]

On the other hand, if banks do not make the necessary digitalisation investments, they will not be able to keep up with developments. There are already at least a few examples of digital actors who have succeeded in rapidly winning market share from banks because these have not been able to produce the services preferred by digital consumers.[7]

If Nordic banks succeed in transforming themselves into banks of the digital age and developing service concepts that are cost-efficient to implement and pleasant to use for the customers, they will also have a chance to gain a foothold outside the Nordic region (see Chart 5 on selected banks' cost-to-income ratios). Naturally, expanding outside one's home market is sensible only if it is financially profitable. Banks need to see that future provision of digital financial services will create economies of scale, and the Nordic market alone does not necessarily provide a sufficient customer base against global competitors. Of course, other reasons may speak in favour of not expanding outside the home market, but one must bear in mind that digital services are often cross-border business, which requires a large customer base. Therefore, drawing up a longer-term banking strategy is difficult at present, which is undoubtedly an unwelcome situation for a conservative industry like the banking sector, which does not value change highly.

Chart 5.

In many countries, the number of bank branches relative to population is many times that of Finland



Source: World Bank.

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Authorities and legislators must constantly juggle between diverging interests: competition, innovation and better customer experience are positive elements but cannot be promoted at the cost of financial stability or consumer protection. If digitalisation leads to financial services provision shifting increasingly from banks to actors that are less regulated and supervised, this could give rise to new risks. On the other hand, when bank's future business models are increasingly based on e.g. algorithms and data analytics, this will also require entirely new skills from banking supervisors. Someone needs to be able to say whether a data set formed by millions of lines of code in different systems is adequately secured against cyber threats.[8]

Notes

1. For detailed information on the DESI index, the underlying components and country-specific data, see the European Commission's website https://ec.europa.eu/digital-single-market/en/desi. ↑

2. For example, the coverage of 4G mobile networks, especially in rural areas. ↑
3. For more detailed information on PSD2, see Effects of the revised Payment Services Directive: first assessment. However, it should be noted that even though PSD2 has already been transposed into national law in Finland, the more specific technical standards will enter into force later. Therefore, the change will not take place in an instant. ↑
4. Although there are numerous estimates available on FinTech investment volumes, according to an estimate by FinTech Global, the 10 largest FinTech investments in the Nordic countries accounted for 80% of the total capital invested in the region in 2017. ↑
5. The bank branch network can be used as some sort of indicator of the level of digitalisation of bank business models, since less offices are needed if the majority of banking services can be offered online. However, it should be borne in mind that the indicator does not directly measure digitalisation in the banking sector, because in Finland, for example, banks began to reduce their branches already during the crisis of the early 1990s. The indicator is also misleading for other reasons in respect of small countries and countries favourable to banks (Luxembourg, Malta, etc.). ↑
6. The European Commission's Digital Single Market strategy aims to enhance the conditions for digital development across Europe. For further information, see https://ec.europa.eu/commission/priorities/digital-single-market_en. ↑
7. One of the most frequently used example is ING-DiBa, a branchless German subsidiary of the Dutch bank ING that only provides digital services in Germany. ING-DiBa is the third largest retail bank in Germany and it is highly profitable, unlike many other banks in Germany. For more information, see e.g. article by The Economist. ↑
8. For more information on cyber security, see Digitalisation poses new security challenges for payment systems. ↑

Keywords

banks, business models, FinTech