

Andreas Dombret: Sitting it out is not an option – what does digitalisation mean for Germany’s banking sector?

Opening speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Bundesbank symposium on “Banking supervision in dialogue”, Frankfurt am Main, 8 July 2015.

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1. Introduction

Ladies and gentlemen

Welcome to the Bundesbank’s 19th banking symposium. I’m delighted to see that we have a full house again and that you have come from all across Germany to join us here in Frankfurt. I’d like to extend a warm welcome to my Executive Board colleagues Johannes Beermann, Joachim Nagel and Carl-Ludwig Thiele. Ms Buch and Mr Weidmann would also like to have been here today, but have prior engagements and send their best regards.

2. The banking sector in transition

Ladies and gentlemen, the computer on board America’s first lunar module weighed around 30 kg. It had the processing power of a pocket calculator, which you can now pick up anywhere for a couple of euro – unless of course you just use the calculator app on your mobile phone or tablet.

Around the time of the US moon landing, well over 40 years ago, the computer gradually started to become a part of life, both at work and, later, at home. Then, almost 20 years later, the internet began to take off too. These days, it’s no longer just the manufacturing industry – under the umbrella of Industry 4.0 – but also banks and other financial service providers that are caught up in a new wave of digitalisation.

The question we have to ask ourselves – you, as bankers, and my colleagues and I as Bundesbankers – is what can our sector do to keep this wave of advancement from dragging us down and instead allow it to propel us forward into new territory?

Don’t get me wrong, the majority of banks started to set up sophisticated IT infrastructures for their core banking business decades ago, with online banking now part of the standard package. However, the current wave of digitalisation is not only simplifying and speeding up individual processes, but also changing many of the rules of the game in banking business.

What is the driving force behind this wave of digitalisation? It essentially consists of three elements which I will discuss in my speech today, namely technology, competition and customers.

It goes without saying that the digitalisation of the financial sector has been fuelled, to a large extent, by the development of highly effective, state-of-the-art technologies.

Thanks to broadband networks, smartphones and advances in data processing, the technical boundaries are shifting so quickly that they practically no longer exist. Thoughts are now turning towards how to put that to good use. Economically speaking, there are all sorts of advantages to digitalisation. With intelligent and well applied IT solutions, you can automate processes and reduce variable costs. No time is wasted in processing, combining and analysing information. At the same time, today’s IT landscape is helping us to eliminate complexity. Last but not least, it enables us to tailor services to our customers’ individual needs.

Another element of the driving force is the emergence of new sources of competition. Gone are the days when it was just banks positioned in what surfers call the line-up, waiting to

catch the best waves. In recent years, companies leading innovation in financial technology, or FinTech companies, have developed a large number of IT-based business models for payment transactions, credit brokerage and investment advice.

Generally, only a small proportion of these innovative ideas and start-ups ever actually make it off the ground. The creativity and innovation of FinTech companies is nevertheless proof of the development potential to be unlocked in the banking sector.

In addition to technology and competition, we must not forget that customers too are part of the driving force. In the past, people considered banking to be something that could only be done in person. Nowadays, encouraged by how information technology has improved other areas of their lives, bank customers are becoming increasingly open to – and sometimes even request – new technological solutions for doing their banking. As I've already said, many people now take online banking for granted, and it is becoming ever more widely accepted, owing to innovative concepts such as online video consultation services, digital credit brokerage and the incorporation of social media into banking.

There is no doubt about it, the digitalisation of the financial sector has clearly taken a huge leap forward and there's no going back. But what will the sector move on to next? Suggestions extend to "banking without banks", that is to say, creating an efficient financial sector without banks. Sometimes the media even pitch banks against their "digital" competitors in a battle to survive.

But of course we still need banks – don't let anyone persuade you otherwise. First, given the variety of accounts they have on offer, they are indispensable, even to innovative financial service providers. Second, they too have a competitive edge when it comes to digitalisation. For example, they are able to cover the entire range of services and lines of business, thereby creating synergies for customers and the institution alike. People also still have immense trust in banks and savings banks when it comes to data security – at least that's what the surveys say. They also continue to appreciate the personal contact with banks, particularly when dealing with more complex financing issues.

In any case, I think it is very unwise to think about the future in black and white terms. Banks are already working together with start-ups and, in some cases, are developing highly innovative concepts on their own. Moreover, many FinTech companies first need a convincing business model before they can really launch an offensive against banks. Lastly, who knows what the sector's next move will be. The recent competition posed by streaming services in the music industry shows how the tables can be turned, even years after the start of digitalisation. That's why, at this juncture, I'm not going to venture a look into the crystal ball, which has become somewhat outdated in the meantime.

Banks and savings banks, however, should be careful not to underestimate developments. Particularly in the field of computer technology, it is sometimes the case that even experts are wrong in their predictions. For example, in 1995 Bill Gates described the internet as just a "passing fad". And in 1943 the then CEO of IBM made an even more unfortunate prediction, saying that he thought there was a world market for maybe five computers. In business, therefore, the old adage still stands: if you don't jump on the bandwagon, you'll soon be left behind.

3. Virtues in the digital age

It is obviously not the supervisors' job to offer you advice on the right strategy for dealing with digitalisation. The successful fate of a business model can be put down to entrepreneurial skills. Ultimately, the markets decide. Nevertheless, I would like to pass on two key messages that I consider particularly important given the digitalisation megatrend.

The first relates to what I was just saying: "sitting it out is not an option". It may seem like a virtue to concentrate on what you're good at and to sit back quietly waiting to see what

changes come. In a period of rapid change, though, this approach would probably lead you to a dead end. If you don't move forwards, you end up going backwards.

Take a look at the industries where digitalisation has already well and truly made its mark. Whether it's the photo and film industry, the music industry or the telecommunications sector, digitalisation has not only made these industries introduce a new medium, but it has also forced them to gain new core competencies. Established enterprises that have been successful up until now are not necessarily failing because they are unwilling to innovate, but rather because they are not prepared to undergo a complete strategic realignment.

Kodak is often mentioned as a cautionary example here. As a producer of film for analogue cameras, Kodak found itself in major financial difficulties when digital photography started to take over. In 2012, the company had to file an insolvency petition and only managed to survive thanks to a radical restructuring.

The risk of being caught off guard goes hand in hand with time pressure. During a period of change, fundamentally new standards and new customs are formed. Once the first trails have been established in the field of digitalisation, there seems to be little point worrying about plotting a course.

Take the area of payment transactions as an example. Competitors such as PayPal or recently Apple have implemented payment systems tailored to consumers in the digital environment. Once customers become used to a new way of paying, competitors offering similar products certainly have a difficult job trying to convince them to switch providers. With their collective push for online payment transactions, German credit institutions therefore find themselves in the unaccustomed role of the attacker. This is precisely why it's so important that members of the German banking community work together to increase their chances.

In summary, I can only recommend that the German banks and savings banks avoid sitting back and waiting for changes to occur, but instead that they actively and intensively tackle the issue of digitalisation and ascertain its implications for their institution. But I get the impression that there is no real tendency in Germany to sit around and wait.

My next message is, in short, "learn the new game rules". Imagine for a moment that you are a football coach. Your team has all the right tactics in place and is doing well this season. Next season, however, the rules of the game are set to change – perhaps the number of goals on the pitch is going up, or more than two teams are to compete on the pitch at one time, or the surface is changing from grass to something else. How would you prepare your team? One thing is clear: you first need to learn and understand the new rules before you can develop a successful game plan.

Let's look at three of the new game rules that I believe could have a huge impact in a digitalised financial sector. You could say that they are the basic digital principles you need to understand in order to find the right tactics.

Game rule number one: the individual needs and wishes of customers are taking on a whole new level of significance. Easily accessible, transparent and personalised services are becoming the norm. In social networks, when shopping online or searching for information, consumers are already used to having their own needs catered to. Customers also want their banking to fit in and keep up with their lifestyle in future – this is especially, but not only, true for the younger generation.

Providers aiming for success need to get into the habit of looking at things from the customer's perspective. Above all, this means being able to cater to different lifestyles and social trends. Companies that manage to build relationships with their customers by providing comfort and accessibility tend to come up trumps. It's no longer about the average customer, but about each individual. The number of goals on the pitch has, without a doubt, increased.

This brings us to game rule number two. Not only is the number of goals increasing, but there are now more players on the pitch, who, incidentally, do not come with the traditional background and qualifications. Competition is becoming more global and more transparent, the competitors more diverse. Online, the customer's next provider is probably just a few clicks away – even across national borders.

And a quick look at the banking supervisor's website won't even help you to identify all these competitors anymore. In addition to FinTech companies, other industries with a strong IT focus are only one step away from the banking world. We are already seeing established online enterprises starting to link their enormous customer bases and their experience in digital processes and data management with banking services. The lines between industries are blurring. Now more than ever, banks need to be aware of what the competition is doing so that they can review and refine their own strategies.

Game rule number three relates to adaptability. If you go from playing on a hard pitch to artificial turf, your tactics need to remain flexible. The digital world welcomes experimentation, is prone to sudden trends, and is constantly changing. Although the banking industry may not always be subject to all of this constant movement, adaptability is definitely becoming more important and relies on a flexible IT infrastructure, for example, to support it. Business models can also be more open and flexible in structure; just think of the "digital ecosystem" strategies banks are now employing. With these strategies, the bank provides a digital platform, the contents of which customers and other service providers can have a hand in shaping.

If you want to survive in the digital financial sector, you need to embrace and play by its new game rules. It's not just the strategy itself you need to examine, but also the thought process on which it is based. If you don't think "digitally", you're going to find it difficult to compete for digital customers.

4. Digitalisation from a banking supervisor's perspective

Ladies and gentlemen, supervisors are interested in credit institutions that are stable and profitable in the long term. At this point in my speech, you may see digitalisation as nothing but a threat to your usual business. But I would encourage you to see it from a different perspective – one from which digitalisation is not the problem but rather the solution.

What currently concerns us, as supervisors, as much as it does you, as bankers, is the lack of profitability in the German banking system, the main cause of which is the prolonged period of low interest rates. Solving the problem of weak earnings is key to ensuring the stability of the financial system – and as you know, this is especially true for Germany. In this regard, digitalisation may very well be part of the solution.

The careful use of information technology can, for example, open up new business areas and boost profitability in the medium term. From easy-to-use, everyday IT applications to "big data" analyses, a large number of potential sources of income are being explored at the moment. And practical add-on services ensure that customers remain loyal to their bank even if competition becomes fiercer. Stability does not mean standing still, which is why it is probably in the interest of the supervisors if banks adapt to new demands in order to retain or even increase their profitability.

But digitalisation also has an impact on the cost side. For instance, the branch network in Germany is still relatively close-knit and therefore expensive. Digitalisation may help banks to continue to reach a large number of customers, even with a less dense network of branches. I look forward to hearing what Mr Buschbeck and his panel have to say on this matter later.

Digitalisation may ultimately also benefit risk management. Making prompt, well-informed decisions is more challenging than ever. Just think of the increasingly complex connections between markets, countries and products, and the growing dynamism of the markets. Efficient IT architecture – by which I mean systems that are consistent, flexible and accurate

– can give institutions a quick overview of their activities and risks. Well-informed decision-makers increase their own chances of success and also protect the financial system as a whole from speculation and knee-jerk reactions.

However, supervisors must also be aware of potential risks to the stability of the financial system. The new playing field and the new players are highly likely to entail new risks. As regulators, we are already committed to protecting critical infrastructures, together with other authorities and the relevant providers. And you may be sure that we will also keep an eye on the new, largely unregulated competitors such as FinTech companies, for example.

Nonetheless, digitalisation also creates new risks for individual banks. The most innovative digital solutions are of little use if they simultaneously open the gates to huge risk. Cyber risk has increased considerably over the last few years. This is because the amount of goods that need protecting has grown: as well as financial assets, personal data and hence access to services are now saved in “cyberspace”.

These days, targeted attacks on IT systems can originate from anywhere in the world. Hackers often need little more than a laptop with internet access. A large number of reasons can motivate cyber attacks, which range from simple attacks by amateurs to meticulously planned attacks with an economic or political background. At the same time, new hacking methods spread through the net at lightning speed and are constantly evolving.

Of course, this is an issue that banking supervisors are also dealing with. IT security is therefore one of the focal points for European banking supervisors in 2015. As always, the Bundesbank and the ECB are working together closely and successfully in this area. At the same time, experts from the Bundesbank recently visited the United States of America to exchange ideas and experiences with banking supervisors there. This exchange will continue after the summer break.

But it's not just targeted attacks that pose a risk. In complex IT systems, in particular, even small system errors can quickly cause enormous damage. Felix Hufeld will address the topic of “cyber risk” in his presentation, so I will make just one final comment. It seems to me that an awareness of these risks does not yet exist at all levels of management at banks. They urgently need to catch up and vastly improve the protection of IT systems and customer data.

5. Conclusion

Ladies and gentlemen, my speech has dived briefly into the wave of digitalisation that has only recently gathered pace and that will inevitably carry the financial sector to new shores.

Everyone involved can benefit from digitalisation, but none more so than private customers in the short term. New technology and stronger competition mean businesses that are even better tailored to their personal needs. Ladies and gentlemen, you must all work towards ensuring that Germany's banking sector does not remain a blank spot on the digital world map.

From my point of view, this requires four things.

- First, every bank needs a “digital agenda” and a flexible strategy.
- Second, every bank must find a balance between existing strengths and new types of banking business.
- Third, every bank must be aware of the problem of IT security and must also pass this awareness on to its customers.
- Fourth, every bank must modernise its IT infrastructure as necessary and ensure that the systems are secure.

Both we, as supervisors, and you, as representatives of Germany's banks and savings banks, have an interest in a banking system that is stable and profitable in the long term. Learning to play by the new rules and actively shaping the process of change is essential if we are to stay on top of the wave of digitalisation. This applies not only to you, but also to the supervisors, because it is not just about detecting and taking advantage of new opportunities, it is also about recognising and limiting new risks. If we can achieve this, we will all successfully ride the wave of digitalisation.

Thank you very much for listening. The Bundesbank's 19th banking symposium is now underway.