



# “Innovation, disruption and change: the Great Disintermediation” - Remarks by Gabriel Makhoul at the 14th SSM Round Table

11 November 2021    Speech

## Introduction

It is a real pleasure to welcome everyone to this 14th SSM Roundtable.<sup>1</sup>

There is an exciting agenda today discussing the key issues of sustainable finance, sustainable business, post-pandemic regulation, and effective ESG supervision.

Given I have the honour of the opening remarks, I want to take a broad view of the dynamics of change in the financial system and the challenges we all face in managing both the process of change and risks from the change itself. The other sessions will go into greater depth on the four key areas I outlined.

Change is a concept that all of us are used to. Reflecting on the last two years, we all adapted very quickly to new ways of working, new ways of engaging, simply because we had no choice – we had to change.

The financial system is always changing. But today’s change feels different and I believe it is different. Different in the pace of change and different in the extent of disruption it is creating. Technology more than anything else is the driver for change, changing how financial services are delivered with far-reaching consequences for the structure of the financial system. This means change for everyone. Firms and regulators need to adapt to the changing competitive landscape.

My remarks will touch on some of these issues: the evolving structure of the financial system, the unbundling and disintermediation of traditional financial services, and in particular the growing participation of non-banks in retail lending and payments. And of course central to the themes of this conference - climate change - a key emerging risk that we all face and which will have the biggest impact on all our lives.

## Technology is driving significant and rapid change

As our lives become increasingly digital, businesses are harnessing the opportunities to innovate and provide new products and services to meet consumer needs and preferences.

The pandemic has moved this trend into an additional gear. A recent McKinsey Global survey reported that firms have accelerated the digitalisation of their customer and supply-chain interactions and their internal operations by three to four years, and accelerated the share of digital or digitally-enabled products in their portfolios by seven years.<sup>2</sup>

For financial services, technological developments around digitalisation, cloud technology and blockchain are driving change and innovation in ways we could not have imagined just a few years ago. In the realm of payments, we have seen an acceleration of digital transformation, with a surge in online transactions and contactless payments during the pandemic.

The competitive landscape is shifting, with new entrants and new business models disrupting the entire value chain of traditional financial services. For my part a big component of the change is the disintermediation of traditional financial services.

It is no exaggeration to say that data is the foundation underpinning this digital revolution, and higher quality data will also be critical in how we move to better understand and address the risks from climate change.

### **... leading to a transformation in the structure of the financial system**

Many of these dynamics were evident long before the pandemic.

Since the Global Financial Crisis (GFC) in 2008, the provision of credit - one of the most fundamental tasks the financial sector provides - has gradually been re-shaped. Credit institutions' share of this has dropped some 14 per cent across the euro area since 2008.<sup>3</sup>

Here in Ireland, the market-based finance sector has more than doubled from €1.8 trillion at the end of 2009 to approximately €5.2 trillion in the second quarter of 2021.<sup>4</sup>

Consumer behaviour has also long been changing. Prior to the pandemic, the proportion of cash used by Europeans for their daily payments dropped from 79% in 2016 to 73% in 2019, and the proportion of card payments increased from 19% to 24% over the same period (in terms of volume).<sup>5</sup>

And the unprecedented shock of the pandemic has accelerated the dynamics of change across the economy and financial system. How households and businesses interact with the financial sector will not be the same again.

All across Europe we see the growing popularity of new businesses who have been expanding their customer base, in particular for current accounts and regular non-lending banking services. This growth reflects how user-friendly their products (or 'Apps') are, as well as the efficiency of the payment and securities settlement infrastructure that supports their activities. This also reflects the underinvestment on the part of banks and other traditional financial services providers over a number of years. Innovations in blockchain technology - although remaining relatively new and somewhat untested - have the ambition to reduce the need for intermediaries such as banks altogether.

Innovation and changes such as these bring challenges, but we must embrace them.

For financial service providers, embracing digitalisation can help cut costs and promote efficiency and competition in certain segments. This should help profitability, which has long suffered in a low interest rate environment.

A recent analysis using the Italian Regional Bank Lending Survey shows that during the pandemic those banks which invested more in IT increased their lending by twice the rate recorded by other lenders.<sup>6</sup>

But it is worth remembering that in embracing digitalisation, there are costs - in the inability of less-digitally advanced customers to access banking services, and the increased threat posed by cyber-attacks, for example.

### **A focus on operational resilience is critical**

The opportunities brought about by the speed and scale of technological change are matched by risks.

The pandemic has led to a realignment in thinking. It is no longer a case of considering 'what if' disruptions occur, but rather 'when' disruptions occur.

An operationally resilient financial sector is important for consumers, firms and markets. Resilience allows us to plan, invest and grow and gives consumers confidence in the services which they rely upon.

Firms must consider whether they have measures in place to limit the impacts of possible disruption and the capacity to maintain the delivery of critical services to consumers and market participants.

Such disruptions can have many causes and sources, for example technology failures, cyber incidents, pandemics and natural disasters. The interconnectedness of the financial system and the extensive use of third party service providers also means operational disruptions can have a systemic impact across multiple firms, sectors and markets, putting financial stability at risk.

Therefore, a flexible, pragmatic and broad approach to operational resilience is needed so that firms have the ability to respond to and recover from unforeseen disruptive events. This should be rooted in the behaviour and culture of the firm, starting with the Board and flowing through into the governance and risk management frameworks.

While the policy landscape is maturing, central banks need to maintain a high level of co-operation globally to ensure system-wide resilience is robust and keeps pace with the evolving environment.

A balance must be struck between maintaining stability and ensuring resilience, but also allowing space for innovation that benefits us all in the long run.

## **Climate Change will have the biggest impact on all our lives**

Many of the challenges, opportunities and risks that I have spoken about emerge from within the financial system. Climate change – the focus of today's conference - is a risk that comes from outside the system, and it is a reality we cannot ignore.

It requires action on the part of all participants in the financial sector, given the challenge to firms and the stability of the system overall. We must all get to grips with these risks and set out clear measures to tackle them.

'Greenwashing' is an area I am particularly concerned about. "Green" market practices are currently almost exclusively based on voluntary principles and standards, which leaves a lot of room for different interpretations. There is a spectrum of risks here from the accidental error to the deliberate misdeed.

The challenge for those overseeing firms is to lead and drive the climate and broader ESG agenda within their organisations.

In the Central Bank we too will play our part and lead by example in our own actions. Just last week I wrote to all regulated firms in Ireland outlining our supervisory expectations regarding climate and other ESG issues.<sup>7</sup> We have also established a Climate Change Unit, which will manage and coordinate our approach to these activities. Climate change was also a key component of the ECB's monetary policy strategy review.<sup>8</sup> Following the conclusion of the review earlier this year climate change is being incorporated into our monetary policy framework.

We are broadening our understanding of the nature of financial risks stemming from environmental change and how interlinkages across the economic and financial system might amplify them.

We must all act now so we do not let the next generation down.

## **We must all adapt to maintain stability and ensure choice for consumers**

As we face the future, we know that the status quo is not an option.

We all need to continue to evolve to be front-footed in our response to these risks and challenges. We must change and transform aspects of all our organisations to ensure we deliver: for central banks - for the public we serve, and for firms - for your customers.

For the Central Bank of Ireland, this change involves us being significantly more open about who we are, what we do, and why we do it.

This strategic change means not just the specifics of regulation when it comes to new products and technology, but fundamentally shifting how we think and how we operate.

Early engagement with innovators, for example, is important and this is one of the chief motivations behind central bank innovation hubs which facilitate two-way dialogue on regulatory challenges associated with new innovations.<sup>9</sup>

And most important of all, in a time of rapid change, we need to be understood and trusted by the public. That is why we want to make a step-change in the way we engage with our stakeholders and create additional opportunities and facilities for us to listen. Next year we will host our first financial system conference bringing together industry, civil society, consumer and business, and I will chair an Industry forum with representative groups.

To be more future-focused and become more open, we have to transform key aspects of the way that we operate. This means a constant process of change right across the Central Bank, always asking how we can do things better.

The evolving environment means we need to help people to do their job to help us deliver more effectively and efficiently. This means investing in new skills and technology as we become digital first and leverage data to make better decisions. There are risks which we are thinking about that cut right across financial stability, consumer protection, prudential regulation, cyber resilience and conduct.

The European regulatory framework has also needed to adapt to the changing structure of the financial system and in response to climate change. The challenge is to develop regulatory approaches that are consistent globally, so that gaps or opportunities for arbitrage are identified and addressed. To ensure our regulation consistently supports the proper and orderly functioning of financial markets globally, we also need to think about whether our focus should be on regulating the activity or regulating the entity.

However, for consumers and businesses these structural changes should ultimately lead to reduced cost and greater choice in accessing finance and in performing day-to-day banking.

## **Conclusion**

To conclude, technology is driving significant and rapid change leading to a transformation in the structure of the financial system. The Great Disintermediation of traditional financial services is underway. We must all adapt to maintain stability for communities and ensure choice for consumers.

Climate change is the biggest issue we all face in our lifetime. The financial system has a key role to play in addressing this.

The overarching challenge is how we manage change, and manage the risks from change. This matters for sustainable finance, sustainable business, post-pandemic regulation, and effective supervision.

For the Central Bank, we are trying to be more open and engaged with our stakeholders and more future-focused in our thinking, actions and policies.

This is the best way we can keep pace with the changing structure of the financial system in order to ensure that it continues to operate in the best interests of consumers and the wider economy.

We all will need to be flexible in the delivery of our strategies while prioritising competing demands, and in safeguarding the delivery of the fundamentals of our work.

Remaining nimble when responding to new challenges and shifting landscapes will be critical as we face the future.

Thank you for your attention.

[1] I would like to thank Luke McNerney, Michelle O'Donnell-Keating, Paul Lyons, Philip Brennan, and Lorcan Byrne for their contribution to my remarks.

[2] See McKinsey & Company, 'How COVID-19 has pushed companies over the technology tipping point—and transformed business forever' October 5, 2020, available here.

[3] From 55 per cent of total euro area financial sector assets in 2008 to 41 per cent in 2021 (source: ECB Statistical Data Warehouse)

[4] See forthcoming Annual MBF Monitor

[5] See 'On the edge of a new frontier: European payments in the digital age', Keynote speech by Fabio Panetta, at the ECB Conference "A new horizon for pan-European payments and digital euro", Frankfurt am Main, 22 October 2020, available here

[6] Branzoli, N, E Rainone and I Supino (2021), "The role of banks' technology adoption in credit markets during the pandemic", Working Paper.

[7] See Letter from Governor of the Central Bank of Ireland to Chairs and CEOs of Regulated Financial Service Providers, 'Supervisory Expectations of Regulated Firms Regarding Climate and Other ESG Issues' 3 November 2021, available here

[8] <https://www.ecb.europa.eu/home/search/review/html/index.en.html>

[9] <https://www.centralbank.ie/regulation/innovation-hub>

[10] See Central Bank of Ireland, Consultation Paper 136 Enhancing our Engagement with Stakeholders, available here

[11] See for example BIS Bulletin No. 45 'Regulating big techs in finance', Agustín Carstens, Stijn Claessens, Fernando Restoy and Hyun Song Shin, 2 August 2021, available here

