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Good news — fintech could disrupt finance

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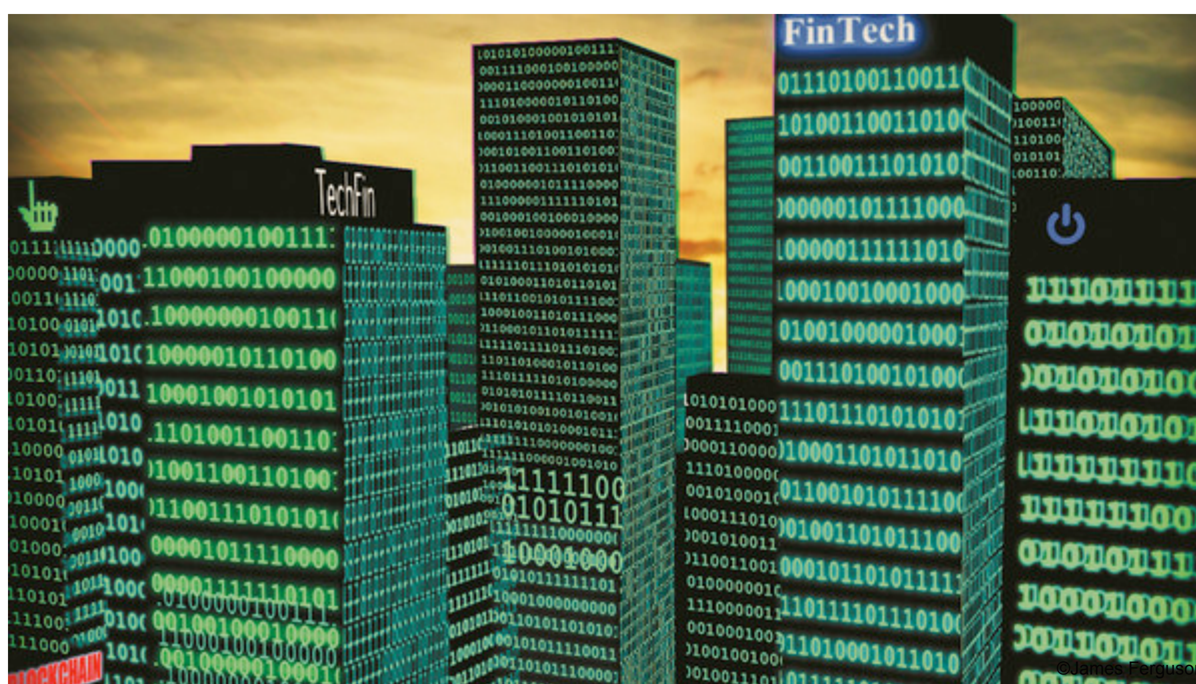
Banking is currently inefficient, costly and riddled with conflicts



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Information technology has disrupted the entertainment, media and retail businesses and, most recently, the supply of hotel rooms and taxis. Is it going to do the same to finance? My first response is: please. My second response is: yes. As Bill Gates has said, "We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next 10. Don't let yourself be lulled into inaction." This advice applies to people in the business itself, but also to policymakers.

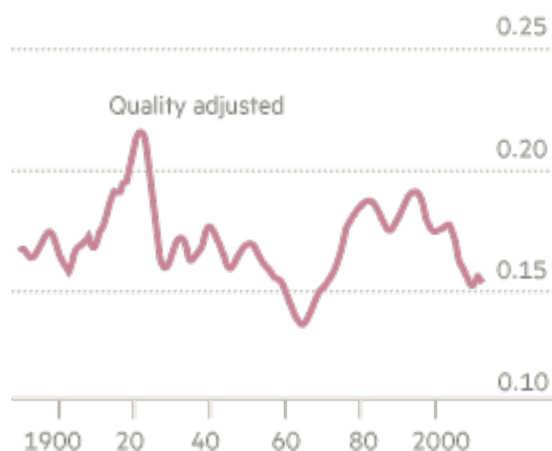
Finance is an information business. Indeed it already spends a higher share of its revenues on information technology than any other. It seems ripe for disruption by information technologies. Consider its three essential functions: payment; intermediation between savings and investment; and insurance. All these activities are information-intensive. People need to know accounts have been settled. They need to

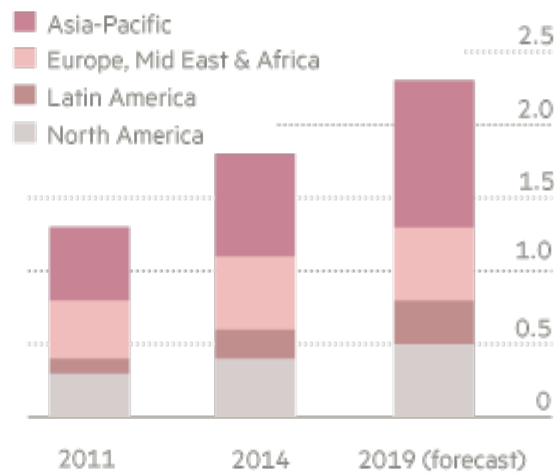
understand how their wealth is being employed and to know that their risks are covered. Not least, the intermediaries need to understand what they are doing.

Today, banks and insurance companies are the core financial institutions. Banks manage payments systems, create most of the economy's money, are responsible for a large proportion of financial intermediation, are creators of financial instruments and act as market-makers and agents. Similarly, insurance companies play the central role in assessing and managing risks.

Why might one hope that new financial technology, or "Fintech" as it is known, will transform these businesses? The answer, especially for banking, is that they are currently not done very well. Banking seems inefficient, costly, riddled with conflicts of interest, prone to unethical behaviour, and, not least, able to generate huge crises.

In a recent speech on the possibilities for a financial revolution, Andrew Haldane of the Bank of England notes that, astonishingly, the unit cost of US financial intermediation seems to be unchanged over a century (see chart). Moreover, income from finance simply rises and falls with the value of assets. That suggests a huge amount of rent-extraction. Additionally, 10m US households and 1.5m UK adults still have no bank accounts. Worldwide, banks generate a staggering $1.7tn in revenue, 40 per cent of the total, from the job of making payments. In the computer age, settlement can still take hours or days.





Sources: Andy Haldane/BoE; Philippon (2014) 'Has the U.S. Finance Industry Become Less Efficient?'; Nesta (2012-14); McKinsey

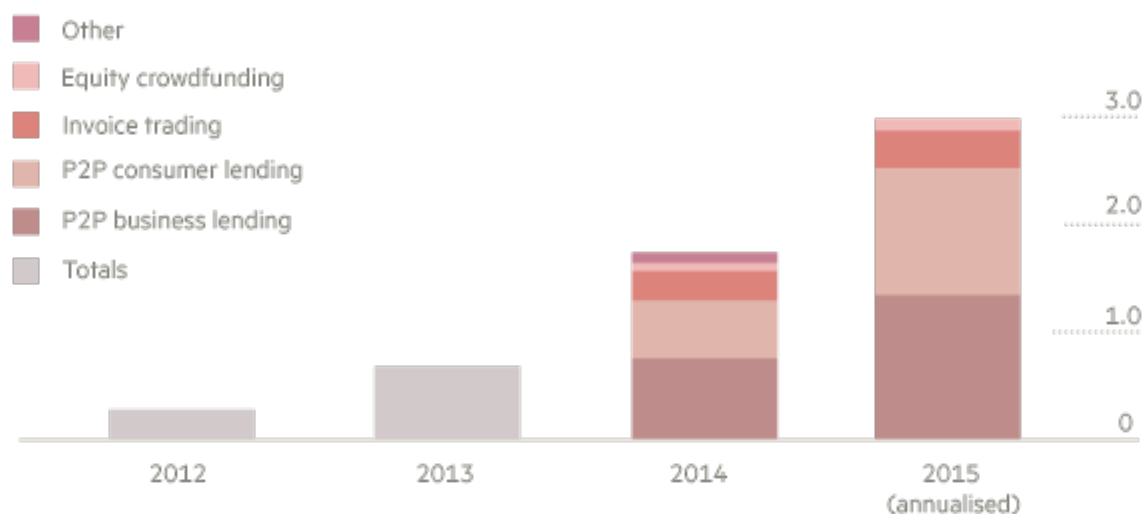
On behaviour, as John Kay has written, "parts of the financial sector today . . . demonstrate the lowest ethical standards of any legal industry". The payment of vast fines seems to be viewed as just a cost of doing business. Finally, the post-2007 banking

crises were as big as any in the past. That their economic impact was not still worse than earlier was due to the willingness of governments to bail banks out.

New technology might help change this in at least two ways. First, it might transform payments. One possibility is real-time settlement via distributed ledgers. The advantages of instantaneous settlement are evident. The advantage of distributed ledgers, an element in bitcoin's "blockchain" technology, is an improvement in the robustness of record-keeping. Instead of centralised accounts, the database would be shared across a network of sites, all of which would hold an identical copy. Such technologies might revolutionise domestic and foreign payments. Many businesses are already pursuing this possibility.

A second transformation might be via peer-to-peer lending, in which new platforms disintermediate the traditional businesses in matching savers with investments. Such lending is growing rapidly (see chart). The theory here is that computerised information might allow savers to dispense with the (costly) services of bankers altogether.

Optimists imagine a future in which payments, the creation of money (unquestionably liquid and safe assets), and intermediation would be separated. In this case, the capacity of the banking sector to create havoc would be reduced and so would the perils created by the state's backstop to private institutions. It is, however, far too early to be confident of such benefits. Indeed it is easy to see that new record-keeping and payments systems would create huge security issues. Similarly, opportunities for malfeasance also exist on peer-to-peer platforms. Indeed, these are inevitable with transactions that rest on promises against an inherently uncertain future.



A further potential source of transformation is via "big data". That might transform the quality of lending, for example, which would be a good thing. But the most striking effects are likely to be in insurance. With new monitoring devices, insurers might gain direct knowledge of the quality of driving or of the state of their clients' health. Such information might be used to motivate improvements in behaviour. But it is also possible to imagine improvements in information so profound that risk pools — the basic building blocks of insurance — disappear. If, for example, the insurer knew with a high level of certainty that some customers would get a given disease, that person might become uninsurable. In insurance, some ignorance is bliss. At the least, the way in which knowledge is obtained and used could create huge social questions.

On balance, the opportunities afforded by the application of information technologies to our financial system seem large. The difficulty might rather be to ensure that the benefits accrue this time to the public rather than to a small number of incumbents or even to their more dynamic replacements. Finance, particularly banking, does need a revolution. But this is one area where policymakers cannot just assume things will work out well. It is because finance is so important that a revolution is needed. But for that very reason the revolution also requires careful watching.

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