



Fintech's new wave: exploring the impact of recession and the banking crisis on the path towards digitalisation

At the beginning of this series, commissioned by Mambu to explore the financial industry's path towards digitalisation, we captured covid-19's effects on digital transformation. We found that the pandemic accelerated the digitalisation of customer interactions by an average of three years and banks' share of digital offerings by seven years.¹ However, at the time, we were also beginning to see the effects of digital transformation fatigue and explored the strategies that the world's biggest banks were deploying to become more agile and customer-centric. Now, a year later, the landscape facing banks has changed dramatically. The pandemic-driven digitalisation boom has come to an end, and the industry is preparing for a global recession. A banking crisis is looming as the collapse of SVB and other regional banks increases uncertainty in the sector.

At this crossroads, it is important to take stock of the progress made and outline the challenges that the digital transformation of financial services will have moving forward. With this purpose in mind, this article revisits the strategies that we initially outlined in the first article of our series and investigates how a recession could affect their development. We aim to better understand how a downturn could tip the scales between front- and back-end innovation, the role that banking ecosystems can play in navigating some of the forces shaping the recession, and how central banks' response to the crisis could create new competition. Ultimately, it will play out very differently from the 2008-09 global financial crisis that unleashed the last wave of fintech expansion. The path towards further digitalisation will continue its course, inviting new players into the industry and leveraging new technologies to transform the operation and provision of financial services.

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¹ McKinsey, "How COVID-19 has pushed companies over the technology tipping point—and transformed business forever", October 5th 2020, <https://www.mckinsey.com/capabilities/strategy-and-corporate-finance/our-insights/how-covid-19-has-pushed-companies-over-the-technology-tipping-point-and-transformed-business-forever>

Not all recessions are created equal

Between 2006 and 2008, two major events unleashed a wave of fintech innovations that transformed the financial system: the introduction of the smartphone and the great recession. Since then, technology has become one of the main assets of the banking industry. For this reason, as we approach the next recession, it is important to understand the impact that this crisis, coupled with new technological developments, will have on banks' paths towards digital transformation.

While there is a temptation to draw parallels between the 2008-09 global financial crisis and its effect as a catalyst of fintech innovation and adoption, it is important to keep in mind the differences in what we are currently experiencing. First, this is not a credit-driven recession.

As financial analysts point out, the world is experiencing excess liquidity, not debt.² Second, the crisis did not originate in the financial system. According to *The Economist's* *The World Ahead 2023* report, the current crisis is being shaped by the economic decoupling between the world's biggest countries, the commodity shock created by the war in Ukraine, and global inflation's impact on macroeconomic stability.³ These challenges are very different from the financial woes that caused the 2008-09 recession. However, despite these differences, it is likely that fintech innovation will still play a crucial role in governments' and companies' response to this crisis.

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Tipping the scales between back- and front-end innovations

Despite the setbacks that the technology industry has experienced as the covid-19 boom comes to an end, digitalisation is not coming to a halt. On the contrary, executives are increasing spending on digital business initiatives in response to the economic turmoil, which could lead to a 5.5% increase on IT spending worldwide, reaching US\$4.6trn in 2023.⁴ However, while enterprises are doubling down on IT investments, inflation is impacting consumers' purchasing power. Spending on digital devices fell by 8.4% in 2022 and is projected to decrease by 0.6% in 2023.⁵ This dynamic could lead businesses to invest more in back-end infrastructures, which have moved, until now, at a slower pace than front-end digitalisation initiatives. As consumer demand for cutting-edge experiences slows, the pressure that companies face for speed and focus in their digital transformation might also fall, leaving more time and resources to go beyond temporary fixes. This could have a positive effect on digital transformation. As we concluded in our previous article, banks need to integrate their front- and back-end infrastructures to realise cost and efficiency savings, and the recession might create the perfect opportunity to do so.⁶

In addition to economic incentives and business imperatives, there are also technological developments that could contribute to accelerating back-end transformation. The rapid development of edge computing, for example, is allowing financial services companies to move data processing to the physical location where these data are created. From a technical perspective, the

2 Morgan Stanley, "How Bad Could the Next Recession Be", June 28th 2022, <https://www.morganstanley.com/ideas/recession-2022-potential-how-bad>

3 The Economist, "The World Ahead", <https://www.economist.com/the-world-ahead-2023>

4 Gartner, "Gartner Forecasts Worldwide IT Spending to Grow 5.5% in 2023", April 6th 2023, <https://www.gartner.com/en/newsroom/press-releases/2022-10-19-gartner-forecasts-worldwide-it-spending-to-grow-5-percent-in-2023>

5 Ibid

6 Economist Impact, "Combatting digital transformation fatigue", https://impact.economist.com/perspectives/sites/default/files/ei_mambu_digtransformation.pdf

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proximity of data to its source can help companies deliver faster insights, better response times and greater bandwidth availability.⁷ In turn, this can generate real-time insights for banks, which is crucial in an industry where every second counts. Low latency applications can help improve banking operations across the board, from executing timely trades to identifying fraudulent transactions, and improving the monitoring and implementation of cybersecurity protocols.⁸

Building digital ecosystems to navigate future shocks

Rapid technology developments are also enabling the creation of entire digital ecosystems, and financial services could play a crucial role here. The expansion of 5G and cloud computing is accelerating the interaction of artificial intelligence (AI) applications, the Internet of Things (IoT), and augmented and virtual reality. These interactions will allow banks to integrate their services in digital ecosystems and contribute to developing immersive digital experiences.

The shape that virtual ecosystems ultimately take will depend on the development of technologies that are still in their infancy. Despite the impending recession, BigTech companies are placing their bets on these innovations. These companies' research and development (R&D) spending was higher in 2022 than ever before.⁹ Investments in AI have become the main focus of BigTech, thereby boosting cloud growth.¹⁰ Regardless of which company gets it right, this R&D spending will spark a new wave of innovation and benefit a broader set of stakeholders across different industries.

One of the technologies that is finally coming of age, and will support a rich financial ecosystem, is the IoT. The average price of an IoT sensor dropped from US\$1.40 in 2004 to US\$0.44 in 2018, alongside cheaper bandwidth and lower processing costs.¹¹ IoT sensors are now widely available and will have important ramifications for the financial services industry. An application that might be particularly relevant in response to the current energy crisis is the role that IoT sensors can play in monitoring and managing industrial energy and power efficiency. As the world embarks on a net zero transition, for example, carbon trading is increasingly being indexed to IoT measurements.¹² Another powerful application of IoT that will impact the industry is its use to determine risk while improving customer engagement and accelerating and simplifying the underwriting and claims process.¹³ These developments are only the beginning of the new wave of fintech innovations that will shape the financial services industry over the coming years.

7 IBM, "What is digital computing", <https://www.ibm.com/cloud/what-is-edge-computing>

8 Techwire Asia, "Edge computing with AI brings real-time insights to banking", July 30th 2021, <https://techwireasia.com/2021/07/edge-computing-with-ai-brings-real-time-insights-to-banking/>

9 Economist Intelligence Unit, "Taking the long view out of big tech", November 11th 2022, <https://viewpoint.eiu.com/analysis/article/762562859>

10 Economist Intelligence Unit, "Data focus: AI is a core investment for big tech", May 15th 2023, <https://viewpoint.eiu.com/analysis/article/1123261295>

11 Microsoft Dynamics 365, "2019 Manufacturing Trends Report", <https://info.microsoft.com/rs/157-GQE-382/images/EN-US-CNTNT-Report-2019-Manufacturing-Trends.pdf>

12 McKinsey, "Seven technologies shaping the future of fintech", November 9th 2021, <https://www.mckinsey.com/cn/our-insights/our-insights/seven-technologies-shaping-the-future-of-fintech>

13 Ibid

Central banks' response and the rise of a new digital challenger

As we've seen in previous recessions, central banks will play a crucial role in steering the global economy to clearer waters. For now, their main focus has been on striking the right balance of monetary policy to control inflation without further destabilising the banking system. Some, like the Swiss National Bank, have become a crucial liquidity lifeline to struggling banks.¹⁴ However, the number of central banks that are attempting to leverage technology, particularly digital assets, to support their efforts is steadily increasing. According to the most recent data from BIS, 86% are actively researching the potential for central bank digital currencies (CBDCs), 60% are experimenting with the technology, and 14% are deploying pilot projects.¹⁵ If successful, this could be the most consequential fintech development for the banking industry in the next decade. It could, in fact, lead to the rise of central banks as a digital challenger to traditional players. This effect is already being seen in China, which is deploying the eYuan as a measure to reduce the country's dependence on Alipay and WeChat, which currently account for 94% of online transactions.¹⁶

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In contrast to the digital cash issued by commercial banks, a CBDC unit has a unique, unchanging digital identity and is a direct liability of the central bank, not the issuing bank.¹⁷ This could effectively make central banks the sole intermediary for financial transactions, leaving banks out of the competition for retail or business cash depositors.¹⁸ In this scenario, the main value that retail banks will add to the customer experience will be distributing electronic wallets with the most innovative and user-friendly solutions.¹⁹ Furthermore, the reputation of established banks as safe custodians of people's money will no longer be a barrier to entry, leaving the field of retail banking wide open for new entrants.

Conclusion

The development of new financial services and products were not the drivers of the rise of fintech during the 2008-09 financial crisis. What led to a true revolution in the industry at the time was the change in the stakeholders that delivered financial services and products and the application of rapidly developing technologies at the retail and wholesale levels.²⁰ While the causes of the upcoming recession differ significantly, its long-lasting impact on the financial services industry might be very similar. If so, the rise and fall of emerging fintech solutions will not only be based on the merits of a particular technology but on banks' ability to step up and help their customers face the world's growing challenges.

14 CNN, "Credit Suisse borrows more than \$50 billion from Swiss National Bank after shares crash 30%", March 15th 2023, <https://www.cnn.com/2023/03/15/investing/credit-suisse-shares-saudi-national-bank/index.html>

15 BIS, "BIS Innovation Hub work on central bank digital currency (CBDC)", <https://www.bis.org/about/bisih/topics/cbdc.htm>

16 Harvard Business Review, "What If Central Banks Issued Digital Currency?", October 15th 2021, <https://hbr.org/2021/10/what-if-central-banks-issued-digital-currency>

17 Ibid

18 Ibid

19 Ibid

20 Arner, Douglas W. and Barberis, Janos Nathan and Buckley, Ross P., "The Evolution of Fintech: A New Post-Crisis Paradigm?", October 1, 2015, University of Hong Kong Faculty of Law Research Paper No. 2015/047, UNSW Law Research Paper No. 2016-62, <https://ssrn.com/abstract=2676553>

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