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Buttonwood: High tech meets low finance

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FROM THE ECONOMIST

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For all the money spent on technology, banking is not efficient

TECHNOLOGY ought to have revolutionised finance more than any other industry. After all, modern money is mostly an entry on a computer--capable of being transmitted instantly and virtually costlessly around the world. Stockmarket activity is now dominated by high-frequency traders, who make deals faster than they can blink.

The finance sector spends more on technology, as a proportion of its revenues, than any other industry. Nevertheless, banking still sometimes gives the impression of a Volkswagen Beetle instead of a Formula 1 racing car. It took many years of effort to get to a world of "T+2", where securities are settled two days after the trade is made, rather than the "T+3" system that preceded it.

The international payments system still looks like a "spaghetti junction", in the words of Andrew Haldane, the Bank of England's chief economist, with money passing through several hands on the way from payer to recipient. The annual revenues earned by the banking system for processing payments are huge, at \$1.7 trillion, and rising (see chart).

One reason for this inefficiency is that technology has been tacked on to a centuries-old banking model. Much bank spending on technology is devoted to maintaining existing systems, a desperate effort to keep the show on the road.

Hence the hype around "fintech"--the hope that the whole system can be overhauled by disruptive innovators, much as Uber is revolutionising the taxi business and Airbnb is taking on hotels. Fintech firms operate in many areas, from digital payments to automated wealth management. But at a London Business School conference this week, the greatest excitement was reserved for blockchain technology. A blockchain is a "distributed ledger" under which transaction records are held by a wide number of participants in a network; it is the technology behind Bitcoin, a digital currency.

Technology experts seem to think a distributed ledger is more secure. A hacker would be required to break into a wide range of sites rather than a single, central register. But there are doubts over whether such a system could handle the sheer volume of payments in the financial system--hundreds of thousands of transactions every second.

Even if those technological hurdles could be overcome, a register could develop in two different ways. An open system would be good for customers, allowing them to exchange money quickly, cheaply and anonymously. But it would be a nightmare for regulators trying to crack down on tax evasion and money-laundering. No longer would the unscrupulous need to keep high-value notes under the mattress. A supervised system would get round this problem, but it would also give the authorities much more power to pry into people's financial lives. Customers would understandably be far less keen.



A largely unregulated technology sector is bumping up against a heavily regulated finance industry. The result may be that advances in this area will be slow as regulators clamp down on anything that seems too anarchic. The big banks, conscious of the ability of regulators to fine them for aiding and abetting money-laundering, will proceed with caution.

Susan Athey, an economist with links to Silicon Valley, argues that blockchain technology might be most useful for other purposes--to register asset ownership, for example. People in developing countries find it difficult to establish their ownership of land; a reliable digital register could reduce that problem. And a digital land registry in America would eliminate the need for homeowners to pay for expensive title insurance.

Forecasting how new technology will change an industry is never easy. As Bill Gates once said, and tech types constantly repeat: "We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten."

But monetary policy may be giving new financial models a lift. Very low interest rates encourage investors to search for yield. One beneficiary is peer-to-peer lending, in which investors extend credit to people and businesses directly. And imagine what would happen if negative interest rates became semi-permanent and were passed on to retail depositors--a tax on bank accounts. The appeal of digital currencies that were out of the reach of central bankers would increase exponentially. Never mind disrupting commercial banks. What about doing the same thing to central banks?

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