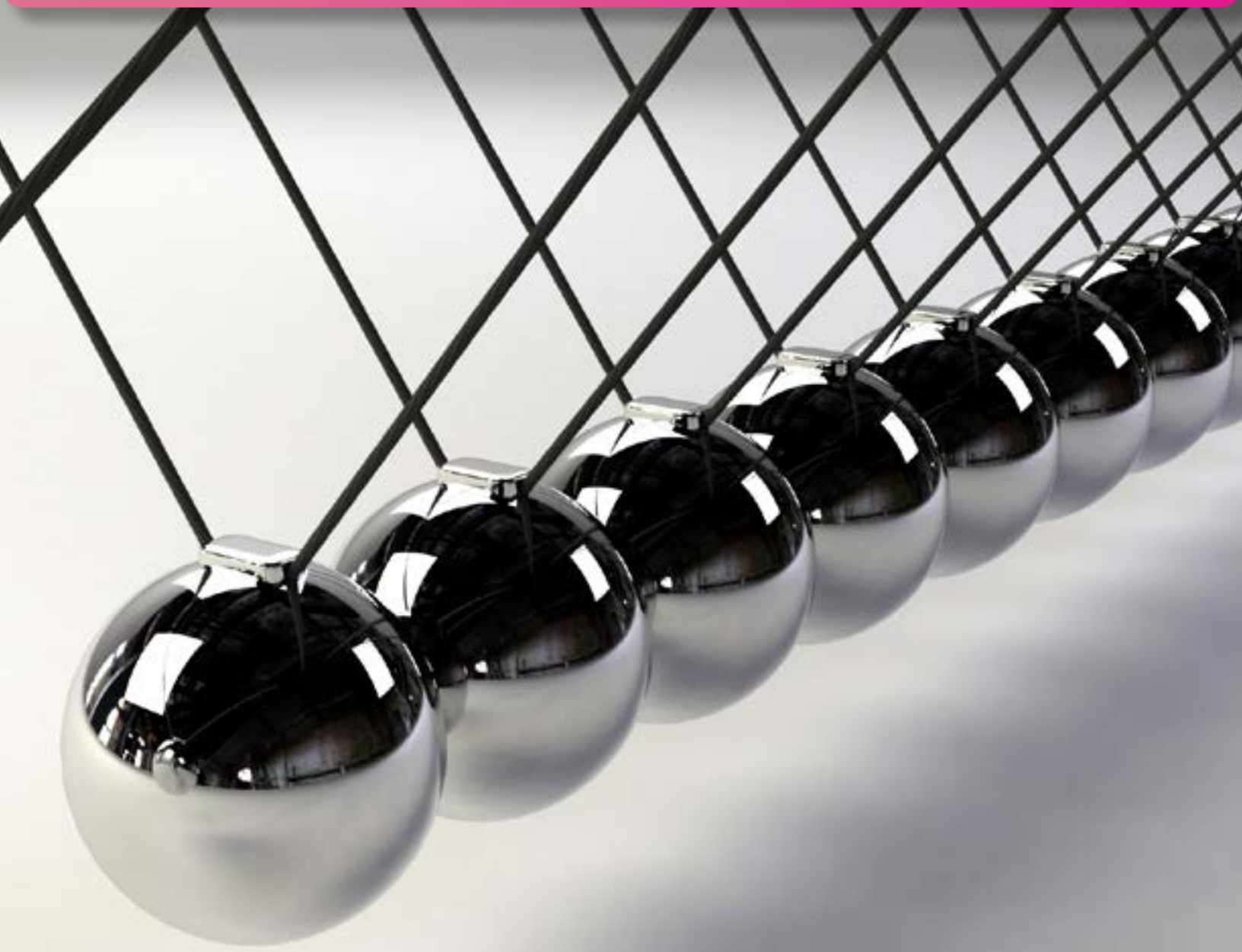
LIMITED DEVELOPMENT OF BIG TECH FIRMS IN CREDIT ACTIVITY: LACK OF INCENTIVES OR BARRIER TO ENTRY?



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Limited Development of Big Tech Firms in Credit Activity: Lack of Incentives or Barrier to Entry?

By Frederic Palomino & Miguel de la Mano

The limited expansion of Big Tech into retail banking activities in the EU (and the U.S.) is, at first sight, a puzzle. Big Tech can leverage certain advantages like network effects and control over entire ecosystems to expand and disrupt the retail banking sector. However, the evidence suggests that Big Tech has made limited advances outside of payment systems in the wealthier countries. We advance several explanations for this puzzle. As it turns out, the overhaul of the financial regulatory framework following the 2008 financial crisis has significantly reduced the profitability of retail banking. To survive and adapt, banks have had to increase their efficiency significantly, further reducing the market's attractiveness for Big Tech. Despite this, Big Techs have likely exerted a beneficial competitive constraint on incumbent banks. This may have led to a period of innovation in retail banking and healthy competition without endangering financial stability. However, competition authorities and banking regulation must cooperate to ensure this balance is not disrupted, and barriers for Big Tech to expand into retail banking are not artificially raised.

I. INTRODUCTION

Digital-technology-based developments have matured to the point whereby a dramatic change in banking and other financial services is possible. Such developments explain the involvement of Big Tech firms in the financial service industry.

In a geographically uniform manner, this entry materialized through the development of payment service activities. For example, M-Pesa, launched in Kenya by two telecom operators, Vodacom and Safaricom, pioneered money transfers outside the banking system, allowing millions without bank accounts to move from 19th-century paper money to 21st-century digital money in a single leap. Then M-Pesa developed its activity in neighboring African countries, in Asia and in Eastern Europe. Today, Google, Amazon, Facebook, and Apple (sometimes collectively termed "GAFA") have a payment service activity on the five continents, sometimes in partnership with other financial institutions. Apple Pay and Google Pay have become household names in some parts of the world.

However, the expansion of Big Tech firms into other financial industry sectors such as credit intermediation, deposit-taking activities, asset management or insurance is highly heterogeneous. For example, in Asia, companies such as Alibaba and Tencent cover the whole spectrum of activities. Ant Group (part of Alibaba), through its online bank subsidiary MYbank, grants credit to SMEs that sell on Alibaba's Taobao market platform. However, outside China, and more generally outside Asia, Big Tech firms are not particularly active as credit providers.

For example, although Rakuten offers asset management and insurance services, and NTT Docomo has developed a small business in the credit sector, the GAFAs have virtually no activity outside payments. In Germany and the Netherlands, they are not present in the market. In France, only a subsidiary of the leading telecom operator is in the market, and in US and UK, their lending volume is smaller than that of Fintech firms.[2] The only notable exception is Amazon, which has a small insurance and credit activity. [3]

The limited expansion of Big Tech into retail banking activities in the EU (and the US) is, at first sight, a puzzle .

First, Big Tech firms can leverage network effects (generated by e-commerce platforms, social networks, or search engines) and technology (artificial intelligence, machine learning using big data) to assess the quality of potential borrowers. For example, in China, based on the data generated by billions of transactions on the Taobao marketplace and historical default data on firm credit, Ant Group can construct automated credit scores and provide small loans to a large number of online vendors.[4]

The Bank of International Settlements reports that Big Tech firms' credit scoring techniques, based on (i) big data, (ii) predictive algorithms and (iii) machine learning, outperform traditional credit bureau ratings in predicting loss rates of small businesses.[5] Moreover, because their technology is already in use for other lines of their business, Big Tech firms can provide credit scoring services at almost zero marginal cost. [6]

Second, Big tech can reduce the costs of enforcing loan repayments. This cost is a key component of total financial intermediation cost. To reduce enforcement problems, traditional banks usually require borrowers to pledge tangible assets, such as real estate, as collateral to increase recovery rates in the case of default. An alternative mean of reducing payment default is monitoring. Banks spend time and resources to limit moral hazard issues such as clients implementing projects differently from what was agreed initially. Through monitoring, firms/borrowers and banks can develop long-term relationships and hopefully build mutual trust, making defaulting less attractive for borrowers. However, as this monitoring activity is costly and time-consuming, banks require compensation in higher interest rate spreads.

Big Tech firms can address moral hazard problems differently. For example, given network effects and high switching costs, Big Tech lenders can threaten borrowers with a downgrade or an exclusion from their ecosystem in case of defaults. Alternatively, suppose a firm/borrower has a large part of its activity related to an e-commerce platform of the lender. In that case, it may be relatively easy for the Big Tech lender to deduct the payments on a credit line from the borrower's revenues that transit through its payment account. As we see, this combination of

2 Cornelli *et al*, 2020, *Fintech and Big Tech credit, a new database*, BIS Working Paper, n°887.

3 *Ibid.*

4 Hau *et al*, 2018, *FinTech Credit and Entrepreneurial Growth, Swiss Finance Institute Research paper*.

5 Frost *et al*, 2019, *BigTech and the changing structure of financial intermediation*, BIS Working Paper 779.

6 Note that the drawback of such technological advantage is that if Big Tech firms screen out bad loans more effectively than the traditional banks (and the FinTech start-ups), then credit risk would be shifted to traditional banks, their investors and their depositors and lending may prove less efficient. See De la Mano and Padilla, 2018, Big Tech banking, *Journal of Competition Law & Economics*, Volume 14: 494–526.

massive amounts of data and network effects would, in principle, allow Big Tech firms to mitigate information and incentive problems traditionally addressed through the posting of collateral.

Third, Big Tech firms benefit from an "uneven" playing field in competition with licensed retail banks in their build-up phase. In some cases, they can partner with licensed banks or FinTech companies to avoid the prohibitive costs of being a regulated entity in compliance and capital requirements.

Despite these advantages, a recent empirical study of the Bank of International Settlements (BIS) confirms the limited presence of Big Tech in retail banking, particularly in high-income countries. The BIS reviews alternative sources of credit in 79 countries. It finds that Big Tech credit intermediation increases with GDP per capita when it is below the GDP per capita level of the 25 wealthiest countries (around $37,000). However, it decreases above that level.

One explanation for this finding is that Big Tech credit is more developed in jurisdictions with a less competitive banking sector. In addition, expected high margins make entry more attractive.

Second, stricter banking regulation is associated with lower levels of credit intermediation by Big Tech firms. This result refutes the argument that Big Tech benefits from an uneven playing field. It appears that it remains difficult for new entrants to launch new lending activities in countries with relatively strict prudential and bank licensing regimes.[7]

Third, in the wealthiest economies, the development of the banking system has gone hand-in-hand with economic development. As a result, a certain level of competition has been achieved and is maintained by competition law and the supervision of competition authorities. For example, the European Commission ("EC") released in 2019 a study on loan syndication. The EC identifies potential competition concerns in connection with (i) information exchange between lenders, (ii) the provision of ancillary services such as the sale of hedging products by syndicated banks, or (iii) the combination of advisory and debt arranging activities, and refinancing situations.

Fourth, following the financial crisis of 2008, recognition of the importance of the banking sector in support of the real economy has led to an overhaul of the supervisory and regulatory framework for financial institutions and, in particular, deposit talking banks. As a result, banks in Europe and North America have made significant investments in improving their efficiency to maintain profitability and restore their capital cushions. This results in thinner margins and fewer incentives for Big Tech to enter these traditional retail banking activities.

Fifth, Big Tech firms have a disadvantage vis-à-vis banks in terms of access to loanable funds. While Big Tech firms can borrow on the bond markets at lower rates than traditional banks,[8] they cannot access deposits. The development of a deposit management activity would come with regulatory constraints that would mitigate the benefit of the reduced cost of access to loanable funds. Also note that, in some jurisdictions, there are regulations imposing separation requirements between banking and commerce/industry. For example, in the U.S., Walmart was refused twice a banking license.[9]

Taking all these factors into account, it seems the expected return on investment is not as high as it is for other projects/activities. Thus, Big Techs may prefer to deploy their vast resources towards other, more profitable, and less risky, non-banking activities.

Big Tech firms' entry into retail banking activities has brought substantial benefits to customers in less developed economies, such as access to credit and overall financial inclusion . Should we worry about the absence of such Big Tech firms in credit intermediation in most advanced economies? In other words, in countries with a developed banking system and a high level of financial inclusion, is the entry of Big Tech into the market socially desirable?

This brings us back to the traditional debate on the trade-off between the level of competition and the financial system's stability. On the one hand, the entry of new firms in the banking sector is desirable as it fosters competition and reduces incumbents' market power. But, on the other hand, under supervision by a strong competition watchdog, a relatively concentrated banking sector is desirable because it favors financial stability.

7 BIS, *Fintech and Big Tech credit, a new database*, BIS Working Paper, n°887.

8 BIS, 2019, *BigTech and the changing structure of financial intermediation*, BIS Working Paper 779.

9 OECD, 2020, *Digital Disruption in Banking and its Impact on Competition.*

At present, the evidence suggests that incumbent banks, including "too big to fail banks," have made significant investments in digitalization, partly in response to the Big Tech threat. As long as that threat remains, we can enjoy a "sweet-spot" period of continued innovation and financial stability. But, competition authorities, banking supervisors and central banks need to work together to ensure retail banking markets work well and systemic risk remains in check. More than ever, imposing unjustified constraints on Big Tech to expand into other services, like banking, could have unintended consequences and damage both competition and financial stability.

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