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Making up for lost time

The race to digitise banks in Latin America

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About this report

Latin America had a late start in the digitisation of financial services but has ramped up its efforts in the past five years, making up for lost time. There is now a bustling ecosystem with over 1,166 financial technology (fintech) start-ups in the region. Governments have also recognised the potential of digitisation and have developed specific regulation to level the playing field between top-tier banks and new entrants. However, banks have faced significant challenges as legacy infrastructure and organisational barriers slow down their digitisation efforts and hinder their ability to cater to lower income customers.

This report—produced by The Economist Intelligence Unit with the support of Mambu— focuses on traditional banks' role in the digital transformation of financial services in the region. Based on a survey of 105 banking executives in Argentina, Brazil, Chile, Colombia, Mexico and Peru, the report explores banks' journey towards digitisation, the role that the covid-19 pandemic has played in their digital transformation, and the ways in which banks are interacting with the growing fintech sector and have the potential to increase financial inclusion in the region.

Introduction

Digital transformation had a late start in Latin America's banking sector but several forces are now converging to speed up this transition. Smartphone adoption has rapidly increased in the region and was set to reach 72% in 2020, compared with 46% just five years earlier.¹ Governments in the region have also recognised the potential of digital financial services to promote greater competition and financial inclusion and have developed specific regulation to level the playing field between top-tier banks and new entrants. This has created an attractive setting for the emergence of a bustling digital financial services ecosystem with over 1,166 fintech start-ups, focused mainly on payment and remittance solutions, lending and enterprise financial management.² Investors have also increased funding for the sector over the past five years, from \$50m to \$2.1bn across 139 deals.³ While neobanks (non-bank financial institutions that provide bank-like services) and digital wallet providers have largely driven the region's digital revolution, traditional banks have slowly but steadily embraced digitisation as well.

Most traditional banks have deployed front-end digital infrastructure to improve the customer experience, including apps and chatbots.⁴ Banks have also prioritised data security, as the region's cyber vulnerabilities have led to significant

losses over the past few years. However, they have faced a significant challenge in modernising back-end operations as a result of the high costs and risks associated with overriding legacy information technology (IT) infrastructure. This will remain a key challenge as banks strive to match the agility of their digital challengers and improve the inefficiencies and high costs that have long held the sector back.

However, digitisation alone is unlikely to bridge the persistent financial access gap in the region, where around 51% of the population remain unbanked.⁵ On the demand side, there is still a major lack of trust in the financial system. On the supply side, banks face some of the highest operational costs in the world, which translate into higher fees and an inability to service low-value accounts. For this reason, banking executives see fintech players as potential partners that can reach new customers and provide a new entry point to the broader financial system. Some are even creating their own digital banks to offer a more diverse front-end experience to users. This collaboration might lead to a shifting landscape, where traditional banks retreat into the background but remain an integral part of the financial ecosystem.

1 GSMA. 2020. "The mobile economy Latin America 2020." [https://www.gsma.com/mobileeconomy/wp-content/uploads/2020/12/GSMA_MobileEconomy2020_LATAM_Eng.pdf]

2 Inter-American Development Bank. 2019. "Fintech activity in Latin America spreads to 18 countries." [https://www.iadb.org/en/news/fintech-activity-latin-america-spreads-18-countries]

3 CBInsights. 2020. "Latin America is suddenly fintech's hottest market. Here are the 3 reasons why." [https://www.cbinsights.com/research/latin-america-fintech-drivers/]

4 Sreeharsha, Vinod. 2019. "Banks finally embrace the digital age." LatinFinance. [https://www.latinfinance.com/magazine/2019/q4/banks-finally-embrace-the-digital-age]

5 World Bank. 2018. "Global Findex" [https://globalfindex.worldbank.org]

Digital transformation in Latin America

Digital transformation is well underway

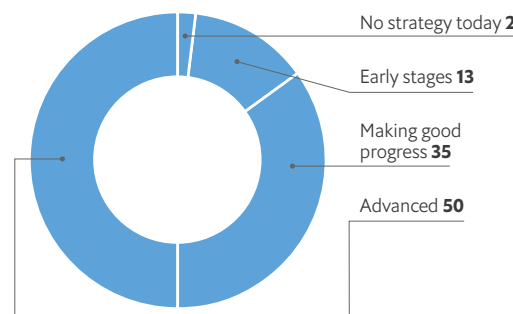
Our survey of 105 banking executives in six Latin American countries found that digital transformation strategies in traditional banks are well underway: 98% of banking executives say their organisations have a digital transformation strategy, and 50% categorise the implementation of this strategy as advanced (Figure 1). Among executives in large banks (i.e. with assets of \$1bn or more), 40.3% report that their strategy is very advanced. Executives in smaller banks and credit unions (i.e. with assets below \$1bn) characterise their digital transformation as making good progress.

Improving data security is the main incentive for digitisation in the banking sector (Figure 2). The region is particularly vulnerable to cybercrime, and data security has been a persistent concern for financial institutions. According to a report by the Organization of American States (OAS), at least nine out of ten banking entities suffered cyber incidents during 2018, and 37% of banks in the region were victims of successful attacks.⁶ The OAS estimates that the total annual cost of banking entities' digital security incident response and recovery in the Latin America region was approximately US\$809m in 2017. In response to these threats, almost 85% of banks have increased their investment in cyber-security over the past three years.

Figure 1

Digital Transformation Strategies

Which of the following best describes where your company is today with its digital transformation strategy?



Source: The Economist Intelligence Unit.

Investment priorities over the next three years are aligned with the main incentives for digital transformation. Fifty-two percent of respondents see investment in artificial intelligence and machine learning solutions as a top priority to enhance their digital capabilities (Figure 3). Artificial intelligence is being used to develop more accurate risk-modelling tools, develop user-centric products and sales outreach, and improve cash management systems.^{7,8} Thirty-five percent of respondents see the adoption of cloud technologies as a crucial investment over the next three years, allowing banks to move away from large investments in IT infrastructure and ongoing maintenance costs.⁹

6 Organization for American States (OAS). 2018. "State of cybersecurity in the banking sector in Latin America and the Caribbean" [<http://www.oas.org/es/sms/cicte/sectorbancarioeng.pdf>]

7 Forbes. 2020. "Solving the small-data problem (and other challenges) with AI: A conversation with Andrew Ng." [<https://www.forbes.com/sites/insights-ibmai/2020/07/07/solving-the-small-data-problem-and-other-challenges-with-ai-a-conversation-with-andrew-ng/?sh=40b8ae802947>]

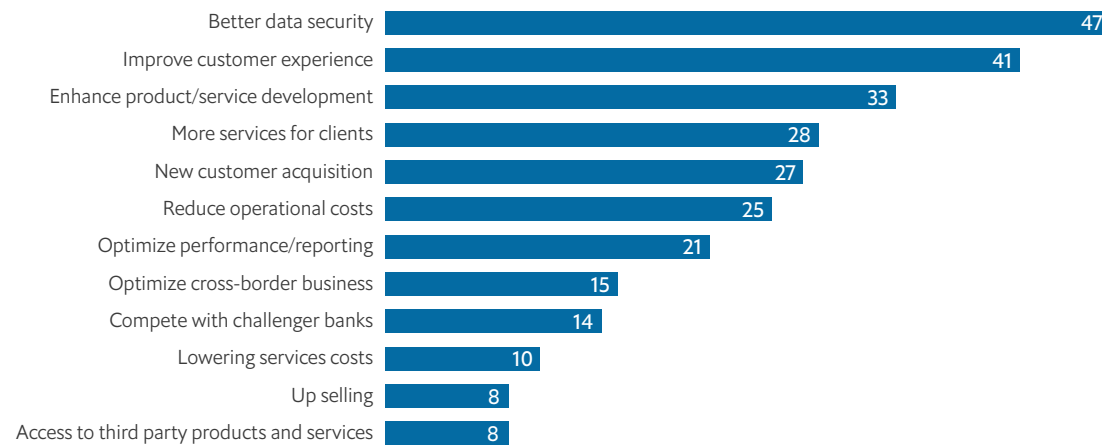
8 bnamericas. 2019. "Latin American banks daring to innovate with AI." [<https://www.bnamericas.com/en/interviews/latin-american-banks-daring-to-innovate-with-ai>]

9 Chuard, Max. 2020. "Cloud and SaaS technology can drive inclusive banking. Here are 3 reasons how." World Economic Forum. [<https://www.weforum.org/agenda/2020/12/cloud-and-saas-technology-can-drive-inclusive-banking/>]

Figure 2

Incentives for digitisation

Which of the following are the main incentives for digitisation in your organization? (%)



Source: The Economist Intelligence Unit.

The covid-19 pandemic has forced the sector to rethink how it runs its business, but barriers to digitisation persist

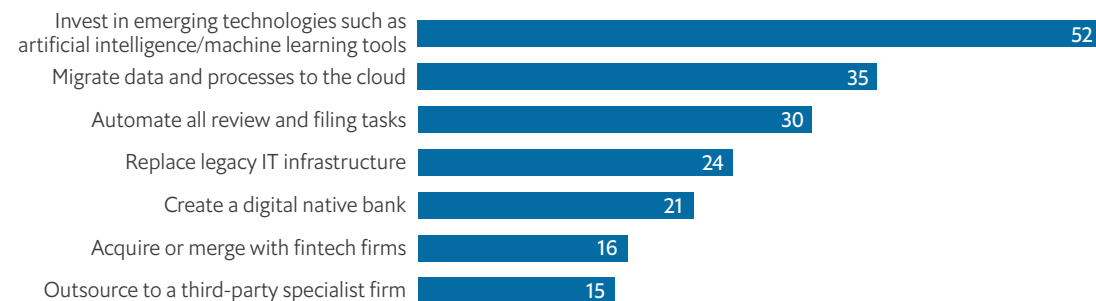
Eighty-four percent of banking executives believe that the covid-19 pandemic has forced the retail banking sector to rethink how it runs its business. However, full digitisation requires broad changes in IT infrastructure and

organisational structures that cannot be easily implemented in the midst of a crisis. Seventy-two percent of respondents have seen either no changes or delays to their digital strategy during the pandemic. The main barriers to digitisation in these organisations include the risks of migrating data into new infrastructures, the lack of alignment between organisational structures and difficulties overriding legacy IT infrastructures (Figure 4).

Figure 3

Priorities to enhance digital capabilities

Looking ahead three years, which of the following should be the top priorities for your organization to enhance its digital capabilities? (%)

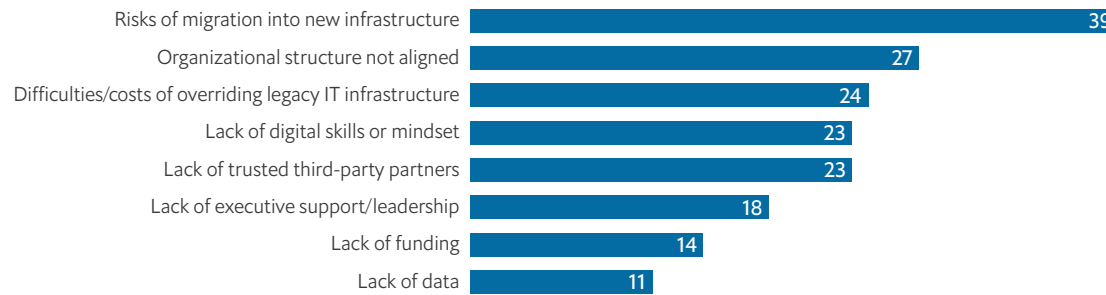


Source: The Economist Intelligence Unit.

Figure 4

Barriers for digitisation

Which of the following are the main barriers for digitisation in your organisation? (%)



Source: The Economist Intelligence Unit.

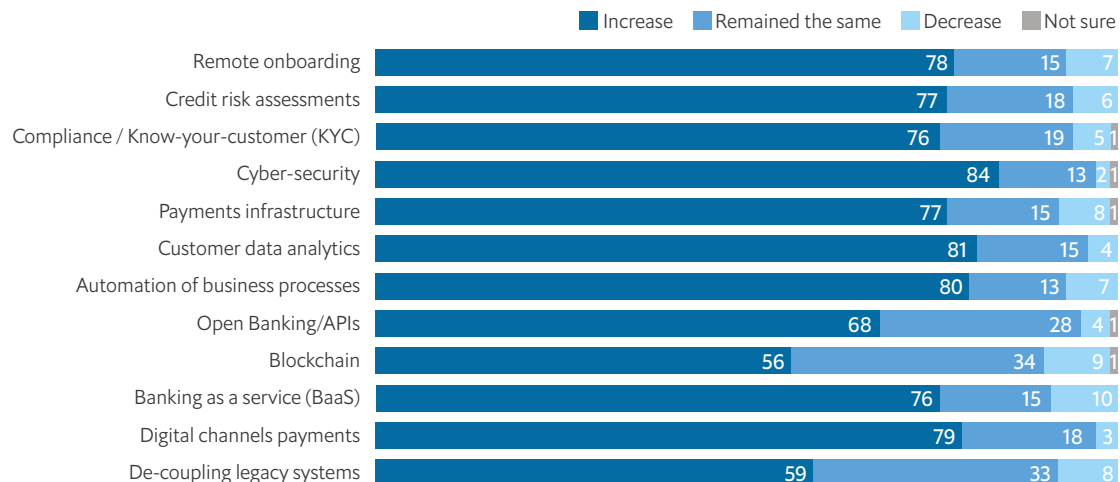
In order to tackle these barriers, banks will need to embrace a more holistic approach to digitisation. Over the past three years resource allocation for the modernisation of core banking infrastructure—including payment infrastructure and the de-coupling of legacy systems—has not been prioritised as much as other areas of digital transformation, such as cyber-security and customer data analytics (Figure 5).

However, executives are optimistic about their organisations' commitment and abilities to digitise their operations. Forty percent believe that they will see a sustained acceleration of their digital transformation strategy as a result of the covid-19 pandemic (Figure 6), likely brought about by changes in customers' behaviours and demands. The pandemic has driven a large uptake of digital payments in the region, particularly as a result of increased

Figure 5

Allocation of resources for digitisation

Which of the following are the main barriers for digitisation in your organisation? (%)



Source: The Economist Intelligence Unit.

Figure 6

Impact of covid-19 in digital transformation

How do you think your digital transformation strategy will change after the covid-19 pandemic? (%)



Source: The Economist Intelligence Unit.

e-commerce adoption. In the first quarter of 2020, 13m Visa card holders in Latin America made their first e-commerce purchase, representing a 6% increase in the region's online shoppers compared with the same quarter in 2019.¹⁰ At this rate, analysts estimate that e-commerce will be used by 60% of the adult population in the region by 2022.¹¹ This increase will demand greater integration between online retailers and banks to reduce friction, as well as the diversification of financial products and services offered through online channels.

Digitisation as a driver of financial inclusion

Beyond the diversification of products and services for existing customers, banks need to focus on increasing their customer base to remain competitive. While 55% of banking executives cite current economic and market conditions as the main challenge to acquiring new customers, their digital counterparts have seen a significant uptick in account opening (Figure 7). According to a recent study, over 40m people in the region have become banked in the past year.¹² However, most of this growth has been absorbed by neobanks like Nubank in Brazil and Uala in Argentina, and by digital wallet providers like DaviPlata in Colombia, which cater to a sector of the population that banks have traditionally excluded.

Few banks see digitisation as a way of reducing banking costs, which remain the most important barrier to financial inclusion in the region. Only 25% of respondents consider the reduction of operational costs to be one of the main incentives for digitisation, and just 9.8% see lowering service costs as a key incentive (Figure 2). This may be an important blind spot

¹⁰ Bary, Emily. 2020. "Visa sees 'massive' digital acceleration with millions trying e-commerce for the first time." MarketWatch. [https://www.marketwatch.com/story/visa-sees-massive-digital-acceleration-with-millions-trying-e-commerce-for-the-first-time-2020-05-13/]

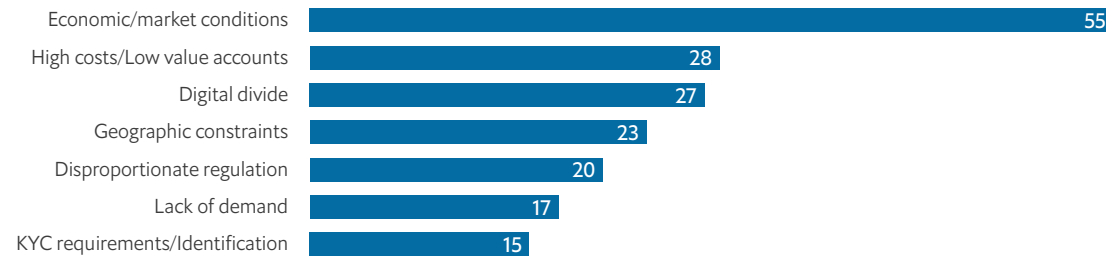
¹¹ Lehr, Lindsay. 2020. "Will digital payments' acceleration under covid-19 last?" Americas Market Intelligence. [https://americasmi.com/insights/will-digital-payments-acceleration-under-covid-19-last/]

¹² Mastercard. 2020. "Digitalization in Latin America: 40 million people became financially included in the last five months." [https://www.mastercard.com/news/latin-america/en/newsroom/press-releases/pr-en/2020/october/digitalization-in-latin-america-40-million-people-in-the-region-became-financially-included/]

Figure 7

Challenges to acquire new customers

What are the main challenges your organisation faces in their efforts to acquire new customers? (%)



Source: The Economist Intelligence Unit.

for bankers in the region. According to the World Bank, 59% of people who do not have access to a financial account in Latin America are constrained by a lack of funds, and 47% believe financial services are too expensive. Latin American banks have some of the highest banking fees in the world, and according to 28% of banking executives the cost of maintaining low-value accounts is a major deterrent to acquiring new customers.

While Latin America's banks are the most profitable in the world, their profit advantage is negatively offset by their lower cost-efficiency, with operating expenses at 3.9% of assets (1.5

percentage points higher than the next closest region).¹³ Digitisation could create important efficiencies in the maintenance and delivery of accounts, as branch networks and cash management systems remain the single largest source of pressure on budgets.¹⁴

Digital banks can leverage technology to reduce operating costs. Large traditional banking institutions have an average cost-to-income ratio (CIR) of 45-55%, while leading digital banks run a CIR of 32-40%.¹⁵ This allows digital banks to offer lower service fees and cater to a broader sector of the population in the region.

¹³ McKinsey & Company. 2019. "Lessons from leaders in Latin America's retail banking market." [https://www.mckinsey.com/industries/financial-services/our-insights/lessons-from-leaders-in-latin-americas-retail-banking-market#]

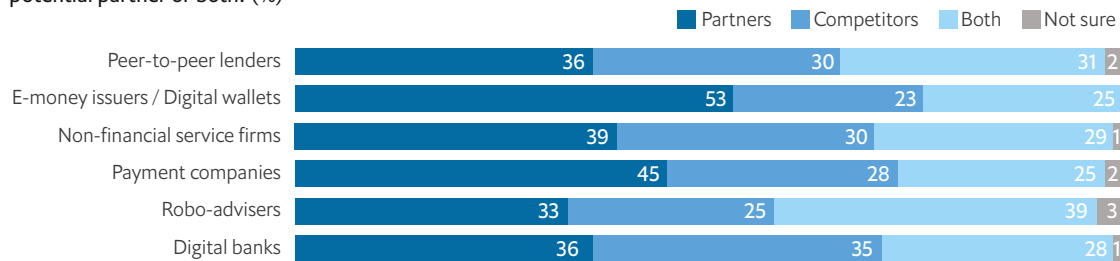
¹⁴ McKinsey & Company. 2020. "Improving productivity in a disrupted landscape: How to transform Latin American banking." [https://www.mckinsey.com/business-functions/operations/our-insights/improving-productivity-in-a-disrupted-landscape-how-to-transform-latin-american-banking]

¹⁵ McKinsey & Company. 2020. "Improving productivity in a disrupted landscape: How to transform Latin American banking." [https://www.mckinsey.com/~media/McKinsey/Business%20Functions/Operations/Our%20Insights/Improving%20productivity%20in%20a%20disrupted%20landscape/Improving-productivity-in-a-disrupted-landscape-Latin-American-banking.pdf]

Figure 8

Non-traditional entrants as competitors, partners or both

Would you characterize the following non-traditional entrants into the retail banking industry as more of a competitor, potential partner or both? (%)



Source: The Economist Intelligence Unit.

Fintechs are complementing traditional banking models

Eighty-seven percent of bankers agree that fintechs are forcing retail banks to rethink how financial services are provided. In particular, fintechs' ability to leverage digital infrastructures to improve operational efficiencies and lower service fees is highlighting the value of digitisation in driving greater financial inclusion.

Most banks see fintech players as potential partners, rather than competitors (Figure 8). Non-bank financial providers can offer mobile products and digital channels that cater to new sectors of the population and can eventually introduce them into the broader financial system. Among our survey respondents, 52.9% see e-money and digital wallet providers as partners, while just 22.5% view them as competitors. These companies focus on digital transfers for low-value accounts but do not have the ability to provide a wide range of financial services. Payment companies like Apple Pay and Paypal are also seen as partners, according to 45.1% of respondents, as they can increase points of sale and strengthen the

digital payments ecosystem. Lastly, 39.2% of respondents see non-financial firms like retailers and telecommunications companies as partners, as they mostly act as banking agents in the region.

Digital banks represent the greatest competition for traditional players, followed by peer-to-peer lenders, according to 35% and 30.4% of respondents, respectively. It is important to note, however, that Latin America does not currently have fully digital retail banks. The so-called neobanks are non-bank financial service providers and are not fully licenced as financial institutions. This means that their deposits are not protected by deposit insurance and they are not allowed to intermediate retail deposits, limiting their operations. However, many of them offer unique products that provide access to the financial system to lower income customers who have traditionally been excluded. The threat posed by neobanks may increase in the near future as they aspire to become fully licenced banks, following the paths of neobanks in Europe such as Monzo and Revolut.¹⁶

¹⁶ Jenik, Ivo, Mark Flaming and Arisha Salman. 2020. "Inclusive digital banking: Emerging markets case studies." CGAP. [https://www.cgap.org/sites/default/files/publications/2020_10_Working_Paper_Inclusive_Digital_Banking.pdf]

Conclusion

Traditional banks are undergoing a digital transformation that has primarily been driven by external forces, including the covid-19 pandemic and the rise of fintech. However, few banks have placed digital transformation at the centre of their growth strategies, and few understand the role that digitisation can play in expanding their client base and strengthening their bottom line. Banks still face important barriers to digitisation, and transforming their legacy infrastructures and organisations will require sizeable investments in the short term. Nonetheless, these investments will be crucial in their search for sustainable digital growth in the long term.

While fintechs are challenging the traditional banking models that have left over half of the region's population unbanked, their ability to provide a full suite of products is limited. Banks will need to cultivate stronger partnerships with fintech players to increase the range of products and services available to their customers. They will also need to develop comprehensive digital strategies to increase productivity and seize the market opportunities that the current environment presents.

While every effort has been taken to verify the accuracy of this information, The Economist Intelligence Unit Ltd. cannot accept any responsibility or liability for reliance by any person on this report or any of the information, opinions or conclusions set out in this report. The findings and views expressed in the report do not necessarily reflect the views of the sponsor.

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