Open Banking: Is that it?

THE ECONOMIC CASE FOR WHY PSD2 CAN STILL SHAKE UP FINANCIAL SERVICES

Nearly six months after the launch of PSD2 across many European countries, the revolution that was promised appears to be on hold. But appearances can be deceptive. A raft of PSD2-driven innovative services have already been rolled out, many of them in northern Europe, and many more will follow once banks and fintechs work out how to use their new PSD2 freedoms to capture the value embedded in banking and payment services. It is too early to write off PSD2 as a catalyst for major change.

PSD2: where things stand

With their permission, PSD2 opens up an individual's banking and payments data so that third-party businesses can offer new or more cost-effective services. Potentially the most powerful of these is a personal financial agent, which would be able to aggregate the details of a customer's financial products and transfer funds between accounts in real time. In this way, the agent would be able to reduce the cost of borrowing and to increase returns from savings and investments, perhaps by recommending entirely new products to the customer.

Some pundits reckoned PSD2 would spell Armageddon for lumbering banks at the hands of fleet-footed fintechs, and/or the "GAFA".[1] Following a long lead-in period, PSD2 became operational across Europe in January 2018. But six months in, banks do not appear to have suffered any significant blows and the general media sentiment is muted at best, and hostile in places. The PSD2 glass appears half-empty.

It is established providers who seem to have made most of the running so far. But this shouldn't necessarily be a surprise. Quite apart from needing to win customer trust, newcomers need deep pockets to build the necessary computer interfaces, bring compelling products to market, and comply with a library of regulations. It was perhaps unrealistic to expect a revolutionary 'big bang' on the day of implementation.

But this isn't to say the fintechs have made no headway, or are not being taken seriously as a possible threat. Most announcements in the first few months of Open Banking have actually come from banks teaming up with fintechs. Examining the trends across Europe, we see three basic interactive models emerging:

- **Genuine partnerships between banks and fintechs**, whereby banks utilise fintech skills to jointly offer something new to bank customers. One example is Bud in the UK, who have worked with HSBC on account aggregation.
- **Placing bets on fintechs**, whereby banks take commercial positions that hedge against fintech success. For example, ING in Belgium has set up an accelerator programme for fintechs. Banks buying up some of the more successful fintechs might be the next logical step.
- **Opening up via Application Programming Interfaces**, whereby banks offer up data to the fintech community. In many cases cooperation on building application software predates PSD2. Examples include Nordea in the Nordics launching an Open Banking site for external developers in early 2017, and ERSTE bank in Central and Eastern Europe recently unveiling an updated API developer hub.

By and large, then, banks are so far holding onto their customer relationships while fintechs, with some exceptions, are reaching customers through existing banking relationships. In addition to these models, many European fintechs are actually focusing on B2B business, such as supporting banks' back-office functions, rather than trying to woo retail customers directly.

[1] "Google, Apple, FaceBook, Apple". PayPal are sometimes also included in this select group, to make a "GAFAP".

This can make economic sense: fintechs avoid the time and cost of building customer trust, while banks are willing to give up some value if more efficient processes save them money and enable them to compete better with other banks.

The future of retail financial services

Capturing the value in retail banking of course extends beyond making sure the back office runs smoothly. How the post-PSD2 market evolves will ultimately depend on the ability to seize or keep hold of the value in retail banking, which can be derived from three main sources:

1) **Assets**. Put simply, there is lots of value in "being a bank": holding a banking licence and being a regulated entity instils trust, as does the safety net of access to central bank facilities.
2) **Capabilities.** Banks add value by managing balance sheet risk and developing products that are profitable for the bank and its customers.
3) **Relationships**. An unarguable truth is that with no customers, there is no value. Customer relationships are therefore very important: being able to acquire customers and to hold on to them underpins the ability to generate value.

The relative importance of these three elements can be illustrated by considering two hypothetical customers in the new world of Open Banking. (With apologies to Ladybird Books): Janet relishes change, John does not.

Janet and John Go Banking

Last year Janet got grumpy with her bank because they were unhelpful when someone stole her credit card details. So, she's keen to take advantage of a "personal financial agent" who can make her life easier. Who might that be?

It could be Amazon. When Janet was buying books for her summer holiday, Amazon offered her a free month of Prime in return for paying directly via her bank account, rather than by debit card. Then when she was buying a new sound system on credit, Amazon suggested a different card with better terms. And yes, of course, they could sell her the new card… Later, Amazon could offer all sorts of helpful financial advice, based on the information Janet agreed to give them access to. She hasn't looked back.

Plenty of other companies are also after Janet's business, including Apple or Google. But once she was comfortable, Janet didn't bother to deal with more than one agent. No more multiple banking websites and apps for her. She trusts her agent to automatically find her the products with the lowest fees and highest savings rates.

Janet still has money with her old bank, but she never talks to them anymore. They sent a letter once saying they now offer a similar personal financial agent service, but Janet didn't believe they would really find her the best deal. She still needs an account, but only in the same way that she needs electricity and running water. Janet can't name her water supplier for the life of her, and there are already days when she can't even remember any longer which bank she's with.

John is bored. He can't see what all the fuss is about over these changes with banking data. He already uses all the new-fangled payment methods like Google Checkout and Apple Pay. Fair enough, his bank was a bit slow to roll out a mobile app, but they caught up before long. And John certainly never felt the need to switch banks. He reckons it'll be the same story this time around. He's interested enough to try innovations such as account-to-account payments, but changing banks? After all those years? Why bother?

John is not stuck in the past. He admits the customer service is better from Amazon and Apple, but he trusts his bank. That's very important to John. It took him long enough to trust his wife to open a joint account with her, so he's certainly not going to hand over the key to his finances to the first upstart fintech that comes knocking.

In any case, when John logs on to his online bank account, he can already call up as many fancy charts and graphs as he could possibly need. Why change?

Janet and John are, of course, extreme caricatures, and most customers are likely to be somewhere in the middle, dabbling with new opportunities but wary of going the whole hog. But to better understand the implications of the behaviour of our hypothetical pair for the new PSD2 world, let's look at the economics behind their respective worldviews.

If everyone thinks like John, customers have never shown much interest in their bank as long as transactions work, their money is safe, and new digital services keep improving. Because customer relationships are sticky, customers, and therefore the value, will stay with the banks post-PSD2. In short, there will continue to be value in "being a bank". The trust banks have built up over decades is priceless. Yes, big banks may be slow and fall down on the latest measures of "user experience". But they largely catch up in the end.

Things are valuable only if they are scarce and can't be replicated, but this isn't the case with much of what PSD2 offers. Even if new digital entrants manage to find and extract value, banks would take just months to match their innovations. The template here is the first wave of innovation in digital and internet banking. Did it open up new ways to interact with banks? Yes. Did incumbents end up forfeiting much value? Not really, no.

If instead the world is made up of Janets, there is still value is the customer relationship, but customers are willing to try new products if it is easier and slightly better. The examples of Amazon, Uber and Spotify all show how customers have shifted in large numbers for better digital experience even though the end product (general merchandise, taxis, music) is the same.

In financial services, nimble newcomers have the opportunity to be innovative in ways that are risk-averse, highly regulated banks with extensive legacy infrastructure cannot. Their capabilities may be different from those of traditional banks, but in the key area of building a simple, intuitive, multi-bank, user experience, these capabilities could be more important.

Trust also takes on a different complexion: it is the Googles and the digital insurgents, not conventional banks, that can be trusted to propose the best financial deals. There will always be a role for banks – and Janet has no intention of closing her account – but the value that accrues to the bank, as opposed to the fintech service providers, will shrink over time. Ultimately, the banks will be used and seen as utilities.

For incumbents and newcomers alike, the challenge will be to adapt to whatever opportunities emerge, which in turn will depend on how people respond to PSD2. In the age of Open Banking it will be arguably more important than ever for all providers to know their customers: who are the Janets, and who are the Johns? And more importantly, how can they be identified and engaged?

Conclusion

It is far too early to predict who will emerge triumphant from the disruption caused by PSD2, and the limited public activity to date may be a poor predictor of what to expect over the next few years. This sentiment appears to be shared across the European financial services community: at recent MoneyLive events in Amsterdam and London, we asked attendees from a wide range of banks and fintechs to estimate what share of banking value would be captured by digital entrants by 2025. More than 60% of respondents plumped for somewhere in the range of 20% to 40%. Now that would be a revolution.

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