Executive Insights

Volume XIX, Issue 57

Open Banking – A Tipping Point for Challenger Banks?

UK banking is on the cusp of a brave new world – open banking. It's a bold step into the unknown with high aspirations – leveraging digitisation and big data to transform the banking experience for retail customers and small and medium sized enterprises (SMEs).

The intention is that product and service innovation will come by opening up banks' customer data to third parties, therefore driving competition and reducing the stranglehold of the big banks.

The hope is that open banking will enable far better comparison of accounts and banking costs than is possible now, make switching more attractive, and foster the development of exciting new offerings. There is much eager anticipation, for instance, about providing customers with a single online platform, optimised for mobile devices, to manage all of their financial services accounts, enable direct payments without going through their bank, and provide financial advice. For cash-starved SMEs, there is the further promise of better access to finance.

Regulation is the catalyst for this change. In the UK, the Competition and Markets Authority (CMA) took action following its 2016 review of competitiveness in personal and SME banking, and in 2015 the EU passed the Payment Services Directive 2 (PSD2). Both regulations require the UK's nine largest banks to make their customers' data available to other banks and fintech companies – with customer consent – and the CMA has set a deadline for implementation of 13 January 2018, through standard open Application Programme Interfaces (APIs).

Open banking provides significant opportunities for astute challenger banks – and their partner fintech providers – with two underserved audiences in particular: smaller and younger SMEs and non-standard retail customers, especially sub-prime. These businesses should be scoping out now how they could benefit from open banking. At the same time the big banks must develop strategies for how they can minimise the potential erosion of their market share by aggressive new competitors and look for new customer-centric approaches to reinvigorating and transforming their customer relationships.

Evolution – not revolution

The full potential of open banking will take some time to realise, for several underlying reasons.

First, the chance of a rush by retail and SME account holders to allow access to their data is slim. The CMA's own research shows that just 3% of personal current account customers, for instance, switched bank in the year before publication of its report, and over half of the people it surveyed were 'very satisfied' and a further third 'fairly satisfied' with their bank – in spite of the potential benefits from moving to another provider[1]. Furthermore, research by Harris-Interactive highlights that only 38% of UK people would be willing to allow access to their banking data; 31% were interested but wouldn't allow access; and another 31% weren't interested at all[2] (see Figure 1). The main issue of concern is data security, privacy and fraud, followed by a lack of knowledge about the opportunity – highlighting the scale of the education task ahead for the challenger banks.

[1] https://assets.publishing.service.gov.uk/media/57a8c0fb40f0b608a7000002/summary-of-final-report-retail-banking-investigation.pdf
[2] http://harris-interactive.co.uk/consumer-appetite-open-banking/

Open Banking – A Tipping Point for Challenger Banks? was written by **Peter Ward** and **Diogo Silva**, Partners in L.E.K. Consulting's Financial Services practice. Peter and Diogo are based in London.

For more information, please contact financial services@lek.com.

Figure 1

Willingness of UK people to allow access to their banking data

Source: Harris-Interactive

Second, once customer data is made available by the banks in January 2018, it is likely to take some time for any challenger bank, fintech company or other innovator to leverage that data to develop new products and services – Big Data is not instantly transformable into Big Insight.

Lastly, with regards to new payments services, it is doubtful if any payment service provider would attempt to launch a new service ahead of the announcement of PSD2's technical standards, which won't be until the fourth quarter of 2018. Furthermore, when this market does take off, security will become an even more critical operational issue for the challengers to get right, as the increasing number of organisations involved in the payments chain and the ease of transacting provides more chances for things to go wrong, with potentially huge negative implications, not least reputational.

The advantages of incumbency - big banks will still be big in an open banking world

Assuming that increasing numbers of retail and SME account holders allow their banks to make their data available to third parties, the big banks will still retain very significant advantages. For example:

1. Data advantages: big banks will have accesss to the very substantial resource that is their own (many millions of) customers' records, so could develop new and more tailored products and services. As customers will likely take some time to allow third party access to their information, it is likely that big banks will still retain a material data advantage vs. smaller players, not least because they will have the same access to new information as new players.

[3] http://www.growthbusiness.co.uk/classification/feature/

2. Economies of scale: although the extent of such economies is the matter of much ongoing debate in a regulatory context, their existence is not. Open banking will not reverse or mitigate this.

3. Funding costs and capital costs: these will also remain significantly higher for challenger banks than the large incumbents; open banking won't flick a switch to enable challengers to write vanilla residential mortgages or prime personal loans profitably, for example.

Lowering the barriers at the margin - targeting underserved SMEs and retail customers

In spite of all of the above, SMEs, especially smaller or shorter-history companies which find it hard to access finance, and non-standard retail customers, in particular sub-prime, are two niche groups that that are likely to remain under-served by the large banks. These could be developed by challenger banks with the right appetite and strategic approach.

Open banking could turn some previously hard-to-underwrite SMEs into attractive loan customers for challengers as it will give the bank real time access to the SME's current account. This access will enable the challenger to conduct far more accurate due diligence on the SME's credit risk, therefore providing them with greater confidence in their lending decisions. Nesta, the innovation foundation, has reported market excitement by lenders interested in this area and the chance to use open banking to build new credit models, especially for young companies[3].

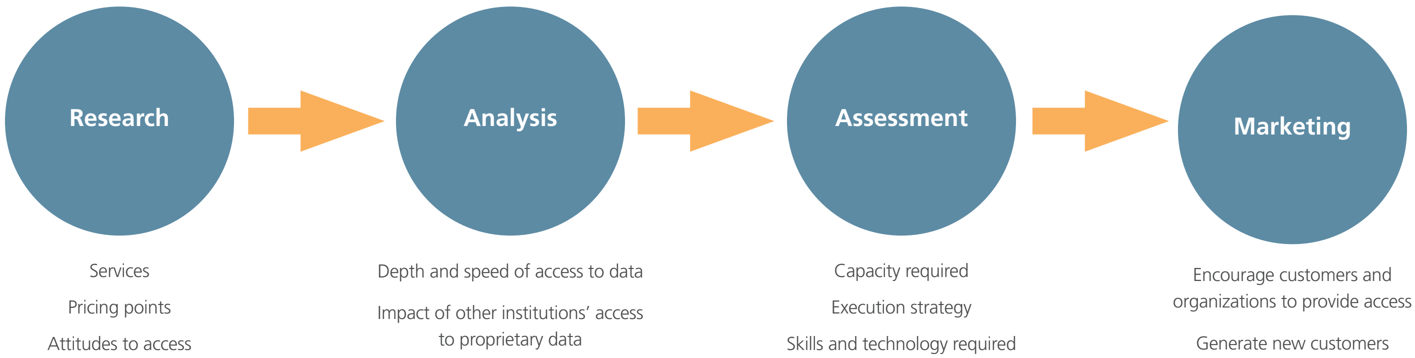
Ambitious challengers could also leverage open banking for SMEs by becoming the easy-to-use online platform that aggregates all of their financial services products and needs, and enables direct payments. Ultimately, over time, this model could enable the challenger to displace the existing current account provider as the lead customer interface without the need to become a current account provider itself – which has many hurdles and disadvantages, not least the cost and weak margins. In this context, the existing current account provider's role could, if incumbents fail to innovate to defend against this, just be one of the services feeding into the customer's comprehensive financial platform.

A second niche for the challenger banks to target is non-standard customers, especially sub-prime, of which there are three further sub-categories: over-indebted people, those with little credit history and those who may have missed payments in the past. Current underwriting processes for these customers are complex, time-consuming, prone to inaccuracy and carry regulatory risk. A key element is often personal interaction either by phone or in person with the potential borrower to help the lender's assessment of their credit risk beyond the mechanical assessment of standard data.

The ability to identify transactions likely to indicate problems "live" is currently one of the key advantages in this space for

Figure 2

Key steps to developing a winning strategy



Source: L.E.K. analysis

incumbents offering card products. However, access to account information, combined with the use of behavioural data about when and where transactions are made – regular purchases from gambling sites, for instance – will help challengers to discriminate between different risk profiles more accurately, partially replicate the personal interaction described above, and reduce loss ratios. As a result, they will be able to underwrite at a lower price for current target customers and hence be more competitive, or underwrite viably a larger set of people at current prices than has previously been possible.

There are also likely to be opportunities for challenger banks with their more mature SMEs and for those that serve more prime customers. Just as the big banks are better positioned to provide tailored services to their existing customers in the era of open banking because they already have access to their data, the same applies to the challengers with regards to their customers.

What banks should do now

In order to make a realistic assessment of where they can compete effectively, banks need first to undertake in-depth customer research by target segment to inform the trade-offs that customers will make in deciding whether to allow access to their data. This will enable them to fully understand the services and pricing points that would be compelling for people and businesses to allow this access, either in considering becoming a new customer or adding further services if already a customer. The analysis should cover a range of scenarios to recognise the uncertainty in how far and how fast this access will be given: each challenger will need to consider how best to increase capability and resources to match a realistic assessment of the number of accessible accounts as it grows.

As well as looking at the opportunity to build market share, banks should use this research to analyse the impact that other institutions' access to their own proprietary data will have on their existing customer relationships and their ability to retain and develop those relationships.

Banks will then need to assess how to build the capability they anticipate needing, scenario-by-scenario, to execute their strategies, paying particular attention to IT requirements and accessing the right skill sets – which can be rare – especially in application development and data analysis.

Given the inherent lethargy bank account holders have towards switching banks and signing up for new services, banks will need to put considerable effort into marketing the benefits of open banking in order to encourage as many people and organisations as possible to provide access to their data as soon as possible after 18 January 2018. In this, they will need to recognise that this will be an ongoing task for some time, likely multiple years.

There are immense uncertainties about open banking and significant profitability opportunity could be some way off. But there are substantial opportunities for banks of all types and size. There could be transformational wins for those challenger banks that take a highly rigorous approach to developing their strategy. For incumbent large banks, in addition to the need to protect against the competitive threat arising from open banking, there is huge potential for renewed relevance and customer-centricity, which could reinvigorate and transform customer relationships.

About the Authors:

Peter Ward is a Partner in L.E.K.'s London office. Having joined L.E.K. in 2000, his primary focus has been corporate strategy development, complemented by substantial experience in buy and sell side commercial due diligence, commercial bid support and litigation support. He also has significant expertise in performance measurement and incentive structures, both within organizations and across contractual boundaries. Peter has deep sector expertise in regulated industries, principally financial services, including advice on regulatory submissions.

Diogo Silva is a Partner in L.E.K.'s London office. He began his L.E.K. career in 2006, having completed an MBA at INSEAD, where he graduated with Distinction. Diogo left in 2010 to join Barclays, where he held roles in the COO office of the Investment Bank and also in Group Treasury. Since re-joining L.E.K. he has focused almost exclusively in the financial services sector, specifically in retail and corporate banking, payment services, specialist lending and asset and wealth management.

About L.E.K. Consulting

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and rigorous analysis to help business leaders achieve practical results with real impact. We are uncompromising in our approach to helping clients consistently make better decisions, deliver improved business performance and create greater shareholder returns. The firm advises and supports global companies that are leaders in their industries — including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. Founded more than 30 years ago, L.E.K. employs more than 1,200 professionals across the Americas, Asia-Pacific and Europe. For more information, go to www.lek.com.

L.E.K.
INSIGHTS @ WORK