Open banking:

A seismic shift

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Open banking is 'one of the biggest changes in financial services in a generation', according to American Banker magazine.[i] The changes enabled by open banking and comprehensive credit reporting will have a significant impact for customers, data privacy and financial crime, strategy and pricing, conduct and fairness, artificial intelligence, and application programming interfaces (APIs). Financial institutions that fail to align their actions in all of these areas 'risk getting left in the dust'[ii]

A seismic shift

Retail banking globally is about to undergo what has the potential to be a seismic shift driven by changing consumer preferences, regulatory changes opening up bank data, and technology-enabled innovation. In the UK, the first nation to launch open banking, the new laws commenced on 13 January 2018. In Australia, the interim report on implementation of an open banking regime[iii] is likely to be released in January 2018. The review, being undertaken by Mr Scott Farrell, a partner with King & Wood Malleson (the Farrell Review), will provide recommendations on the design of the operating model and regulatory framework for the introduction of open banking in Australia. In addition, the interim report on competition in the Australian Financial System by the Productivity Commission will include comments on data availability and use and is expected to be released in early 2018.

Banks and other financial institutions have traditionally retained ownership of the customer relationship and, crucially, of what was perceived by them to be their customer data.

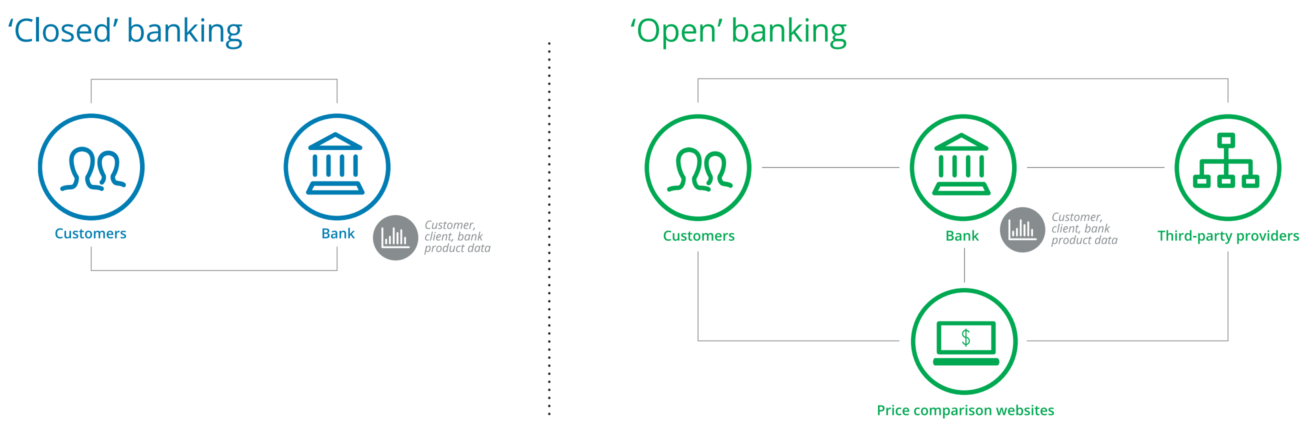
Ownership has long provided incumbents with a significant competitive advantage in terms of pricing and risk scoring, compared to new entrants. And because the value of data grows exponentially, a larger bank has had a greater advantage than a smaller bank.

The evolution from a closed model, where each financial institution retains and controls the information it collects about its customers, to an **open model**, where customer data is shared, referred to as open banking, has the potential to change competition in the sector and see the creation of new products and services based on that data.

Notes

[i] Lemon, Stephen, *Will banks catch the open-banking wave, or be engulfed by it?*, American Banker, 29 November 2017.
[ii] Ibid.
[iii] Productivity Commission, *Data Availability and Use*, Productivity Commission Inquiry Report, No 82 31 March 2017. See also: https://treasury.gov.au/review/review-into-open-banking-in-australia/terms-of-reference/

The 'opening up' of customer transaction data:



Source: Deloitte, Open Banking, How to flourish in an uncertain future, June 2017.

Data has changed the game

Customers provide financial institutions and banks in particular, almost literally, with a wealth of information. Demographic information about a person's age, residence, employer and family. Financial information on a person's assets, wealth, income and expenses. If a person has a credit card or transaction account, banks can gather information about what he or she spends their money on. Banks can glean behavioural insights from this expenditure data: Where and when do you shop? What do you buy at what time of day? How do you pay for these items?

Banks can also start to draw conclusions about your credit profile, or your likelihood to require financial products and services. For example, how the nature of your expenses influences the likelihood that you will miss a payment or default on a loan. They can even look at your employer's cash flow and assess what that means for your likelihood of an unplanned loss of work.

The Final Report of the Financial System Inquiry (the Murray Report) in 2014 noted:

"More comprehensive sharing of credit data would reduce information imbalances between lenders and borrowers. It would also facilitate borrowers switching between lenders and greater competition among lenders. Overall, more comprehensive credit reporting would likely improve credit conditions for borrowers, including SMEs." [iv]

The Australian Treasurer, Scott Morrison, noted in the 2017 budget speech, the government's aspirations for open banking's impact on competition:

"The introduction of an open banking regime in 2018 will give customers greater access to their own data, empowering them to seek out better and cheaper services." [v]

As it becomes easier for customers to switch between current account providers and shop around for other products based on price, incumbents are at risk of losing market share and seeing reduced profit margins.

The competitive advantage they have experienced may now be eroded as customers take control of their data and data is shared with third parties. Moreover, third parties may be able to create new propositions that meet unmet needs, using data to give the customer tangible benefits. As a result, incumbents could lose the primary banking relationship if customers increasingly choose to manage their finances via a third-party interface.[vi]

Of particular concern for banks would be third-party interfaces that allow customers both to manage their finances and to switch providers via one app. In this scenario, incumbents risk losing both market share and the primary customer relationship.

The CEO of the Australian Bankers' Association, Anna Bligh has said:

"Open banking will enable customers to get more value out of their data by opening it up to be easily shared with other banks and finance providers. In the future, a customer will be able to open their mobile phone app and with the touch of a button, direct their bank to transfer their data to another finance provider.

Giving customers the ability to share their data more easily will help them to shop around for deals and get the best product for their needs.

This represents a significant change from the current system and puts the power squarely in the hands of the customer, allowing them to decide how and when, or if, their information is shared." [vii]

Open banking will require a fundamental rethink of the traditional banking business model. Opening up bank data carries an inherent threat of commoditisation for incumbent banks[viii]. At the same time access to customer data will enable new entrants to be more competitive. Customers may see their primary relationship being with a fintech, a technology company (increasingly referred to as techfins), or a price-comparison website, with banks relegated to product manufacturers or payment infrastructure utilities.

Open banking also has the potential to facilitate the creation of new, data-based, services. In this environment, incumbent banks can choose from four non-mutually exclusive operating models:

- **Full-service provider:** continue with a full-service offering, delivering proprietary products via a proprietary distribution network with little or no integration with third parties.
- **Utility:** relinquish ownership of products and distribution to operate as a utility, providing other players with infrastructure and non-customer-facing services.
- **Supplier:** continue to offer proprietary products but relinquish distribution to third-party interfaces.
- **Interface:** concentrate on distribution by creating a marketplace interface through which third parties can provide products and services.

Notes

[iv] Commonwealth of Australia, *Financial System Inquiry: Final Report, Chapter 3, Innovation,* November 2014, p191
[v] Morrison, Scott, Treasurer of the Commonwealth of Australia, Second reading of the Appropriation Bill (NO 1) 2017-18, , 9 May 2017. See also http://www.budget.gov.au/2017-18/content/speech/html/speech.htm.
[vi] Deloitte, *Open Banking, How to flourish in an uncertain future,* June 2017. See also: https://www2.deloitte.com/uk/en/pages/financial-services/articles/future-banking-open-banking-psd2-flourish-in-uncertainty.html.
[vii] Australian Bankers' Association, *Open banking a big win for consumers,* 21 November 2017. See also: http://www.bankers.asn.au/media/media-releases/media-release-2017/open-banking-abig-win-for-consumers.
[viii] Deloitte, *Open Banking,* op. cit.

It is already here…

In Europe, the UK's Competition and Markets Authority (CMA) has mandated that the UK's largest banks adopt the Open Banking Standard. Across the EU, banks are required to comply with the revised Payment Service Directive (PSD2).

In Australia, the interim report of the Farrell Review was provided to the Treasurer in late December 2017 and is expected to be released in January 2018. The Farrell Review will provide recommendations on the design of the operating model, the regulatory framework, and the roadmap and timeframe for implementation of open banking in Australia. In addition, it will cover critical issues around data security, privacy and fairness. This follows the final report of the Productivity Commission on Data Availability and Use which was released in May 2017.[ix]

In addition, the first phase of **Comprehensive Credit Reporting (CCR)** will be introduced from 1 July 2018. CCR allows credit providers to provide positive credit information on individuals, such as loan repayment history. The Murray Report noted that: *'Empirical evidence suggests CCR reduces the likelihood that originated loans will default (reducing interest rates) and/or increases the availability of credit'*[x] and concluded that *'CCR would lead to better credit decisions across the system'*.[xi]

Risk and data privacy

As open banking enables personal information to be shared between organisations, **data privacy** will become critical, along with the ability to gather, record and manage customers' consents and permissions. Australian financial institutions' Data Protection Programs[xii] have been designed to comply with the Australian Privacy Principles and Privacy (Credit Reporting) Code introduced in 2014. In May 2018, the European Union's new **General Data Protection Regulation (GDPR)**[xiii] comes into force in the EU. Both GDPR and PSD2 are built on the principle that individuals own their personal data and should therefore be able to choose how it is used and with whom it is shared. Australian data protection programs may need to be reviewed to ensure regulatory compliance with the EU's GDPR, or to manage reputation risk, given that the EU's GDPR is likely to become a benchmark against which financial institutions will be assessed in the court of public opinion.

The growth of third parties in the provision of financial services is likely to impact **financial crime** risk management and reporting. The delivery of a package of financial services across an ecosystem of different providers, the growth of electronic identification and verification, and the emergence of non-bank platforms for peer-to-peer lending and crowd-funding all have implications for financial crime risk management.

Pricing and Conduct

As occurred with the introduction of securitisation, open banking will likely require banks to more accurately model risk and profitability, a customer's willingness-to-pay, and overall life time value (including cross and up-sale). The adoption of **strategic pricing,** including **risk-based pricing**, and the removal of cross subsidisation between customer segments will result in better pricing for lower risk customers.

However not all customers will get better pricing. It will be important for banks to thoughtfully consider the way in which pricing will take into account considerations around **conduct and fairness**. Strategic pricing has the potential to result in higher pricing (rates and /or fees) for vulnerable customers or a restricted ability to access credit. These considerations are likely to impact disproportionately on the major banks because of their legacy customer base.

If everyone is competing for the better risk customers, what social banking obligations should organisations have to avoid financial exclusion? How do you make sure that these apply equally to new entrants as to incumbents? What information do financial institutions need to communicate to a customer if they are charged a higher price, or if access to credit is declined?

Enabled by advances in technology

In an open banking environment the ability to exploit and use customer data in innovative and more individually tailored propositions will be paramount. Banks that invest in **artificial Intelligence, analytics, automation and algorithms** and related capabilities will add value to consumers by being able to build personalisation into products, services and customer interactions.

Cognitive insight can be used to detect key patterns and relationships in real time from multiple data sources, such as financial history and social media, to drive deep actionable insights. This will also help banks to better understand the way customers process information and make decisions.

Cognitive engagement then uses these insights with individual customers to offer personalised services. This approach could eventually drive actions in real time; for example, by using deep understanding of spending patterns, banks could flex overdraft limits for individual customers. This may help banks improve customer satisfaction and profitability.

Cognitive automation through AI combines machine vision, speech recognition and machine learning with breakthroughs in computing power. As a result, it can automate processes through interpreting facts, taking decisions and adapting to change through self-learning.[xiv]

Open banking has been made possible by advances in technology that provide new functionality for consumers and banking entrants alike. The most notable of these, **application programming interfaces (APIs)**, allow developers to incorporate third-party data and services into their applications. In the UK, the Competition and Markets Authority (CMA) made it mandatory for the UK's largest banks to open up their retail customer and SME account data. These banks need to make shared data available through open APIs by the PSD2 implementation date of January 2018.[xv]

While PSD2 only opens up access to customer transactional data for specific institutions, the CMA has set up separate arrangements under which price-comparison websites can become authorised to access customer data.[xvi] Similar arrangements are likely to be adopted in Australia.

Notes

[ix] See also: https://www.pc.gov.au/inquiries/completed/data-access/report
[x] Financial System Inquiry: Final Report, op. cit. referencing International Finance Corporation 2012, *Credit Reporting Knowledge Guide,* International Finance Corporation (part of the World Bank), Washington, DC and Barron, J and Staten, M 2003, *'The Value of Comprehensive Credit Reports: Lessons from the U.S. Experience', in Credit Reporting Systems and the International Economy,* ed. Miller, M, MIT Press, Boston.
[xi] Financial System Inquiry: Final Report op. cit.
[xii] Deloitte, *Five privacy trends for Australian organisations in 2017,* January 2017. See also: http://blog.deloitte.com.au/five-privacy-trends-for-australian-organisations-in-2017/#.Wl7y0Bt95qM.

[xiii] Deloitte, *The General Data Protection Regulation – Long awaited EU wide data protection law finalised,* May 2016. See also: https://www2.deloitte.com/nl/nl/ pages/risk/articles/the-general-data-protection-regulation.html.
[xiv] Deloitte, *Open Banking,* op. cit.
[xv] Competition and Markets Authority, *Retail banking market investigation final report,* 9 August 2016, p.441. See also: https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf.
[xvi] Ibid.

Deloitte's Open banking series

Over the next few weeks, we will be exploring the topics noted in this paper.

Opening up customer transaction data is likely to lead to increased competition in retail banking and facilitate new customer propositions. This will just be the beginning. In the longer term, open banking is likely to facilitate a much more radical transformation of the sector, one that completely changes the dynamics of the retail banking landscape and the retail banking business model itself.

Financial institutions will need to learn to operate in a shared ecosystem, moving away from the currently closed environment to one where they need to work more closely with third parties.[xv]

Incumbent banks have much to consider if they are to thrive in this future landscape. However, they cannot afford to stand still. By improving their ability to optimise their use of data and embracing opportunities to automate, incumbent banks will be well positioned to maintain the customer relationship and, ultimately, to win in an 'open banking' world.

Notes
[xvii] Deloitte, *Open Banking,* op. cit

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