What is Open Banking and how can traditional banks benefit from them?

Introduction

Open banking is a rapidly growing industry with a market size valued at US 20.2 billion in 2022 and a projected CAGR of 20.5% from 2023 to 2032, fuelled by the escalating demand for digital banking. Simply put, open banking refers to a system that facilitates third-party financial service providers in accessing customer banking data, with the explicit consent of the customer. This access is granted through Application Programming Interfaces (APIs) made available by traditional banks. Although they might initially appear to be on the losing side of the equation, mainly because they lose their historical monopoly over their clients' financial data, traditional banks have the opportunity to strategically harness open banking to enhance their operations, enrich customer experiences, and fortify their competitive position in the evolving financial landscape.

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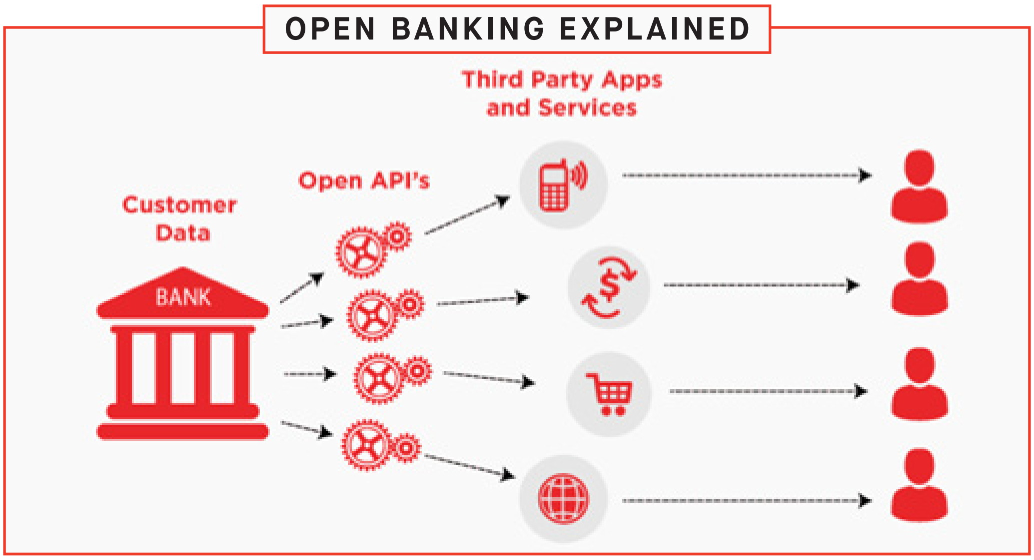
PRIVATE BANKING

What is Open Banking



Open banking, according to the Swiss Bankers Association (SBA), incorporates a business model founded on the secure and standardized exchange of data between the bank and trustworthy third-party providers, which may also encompass other financial services entities. The SBA defines three key principles of open banking.

- "Standardized" denotes the necessity of standardized interfaces to facilitate seamless third-party integration and error-free data exchange, ideally based on established market standards
- "Secure" emphasizes the imperative need for technological safeguards to ensure data confidentiality and security.
- "Reliable" highlights the importance of maintaining system integrity by granting third-party access to the interface only after meeting stringent quality criteria and adhering to the highest technical requirements.

The pivotal element of this framework is collaboration, involving partnerships among traditional banks, FinTech companies, technology providers, and regulatory bodies. Traditional banks function as the custodians of customer data, ensuring its security and privacy, while FinTech firms harness this data to design and develop innovative solutions, meeting the evolving needs of consumers. Notably, major companies in the open banking market, such as Finicity (MasterCard), TrueLayer, Plaid, Tink, Yodlee (Envestnet), Tibco Software, Capgemini, Oracle, and Accenture, invest heavily in innovation through strategic partnerships and product development.

Open banking can be propelled either by regulatory mandates or market forces. When it is regulatory-driven, banks are obligated to share transaction data and permit third parties to initiate payment transactions. For instance, the European Union, including the UK and EU member states, mandates banks to open their data to third-party providers upon customer consent, notably through the revised Payment Services Directive (PSD2). On the other hand, in a market-driven approach, traditional banks are invited to partake in open banking initiatives. Regions like the United States and Asian countries such as Hong Kong, Singapore, and Japan predominantly follow a market-driven approach. Switzerland is likewise embracing this approach, in line with its inclination for efficient and market-responsive financial solutions. In either scenario, whether regulatory or market-driven, the customer is always the one making the decision to share their data. This fundamental principle underscores the importance of customer consent and control over their data, ensuring a customer-centric approach within the open banking framework. Open banking enhances financial transparency and access, empowering the customer with improved financial management, real-time insights, and a wider array of services.

One of the most widespread applications of Open Banking involves initiating account-based payments. This initiative aims to reduce processing costs, optimize cash flow cycles, and enhance the overall customer experience by seamlessly integrating payments within their journey. The range of applications also encompasses recurring account-to-account payments (for instance, variable recurring payments), financial risk assessment including affordability checks and credit scoring based on a consumer's transaction history from their existing accounts. Additionally, Open Banking finds utility in "Know Your Customer" (KYC) procedures, which include account ownership verification, tenant vetting, fraud mitigation, and insurance underwriting.

How can traditional banks benefit from them?

Contrary to many predictions that anticipated the demise of traditional banks, open banking is far from being the end of legacy banks. Although traditional banks may be seen on the losing side of the equation, mainly because they lose their historical monopoly over their clients' financial data, open banking was not designed to outrank them but instead as a powerful ally.

1. Enhanced Services and Innovation

Traditionally, banks handled all aspects of their services internally. However, the changing dynamics, with the rise of Open Banking, suggests a departure from this traditional approach. A shift towards specialized banking functions is becoming more prominent, offering customers greater freedom from bundled financial services offered by their primary banks. This empowerment allows them to opt for a wide range of financial products and services from various FinTech companies or even alternative banks, tailor-made to meet their specific requirements. For many banks, this represents an opportunity to streamline their extensive product offerings by divesting less profitable segments or outsourcing them to specialized FinTech firms equipped with the necessary resources and dynamism. It levels the competitive playing field, providing new players with an opportunity in a market once monopolized by established banks. Open banking prompts traditional banks to innovate, especially in response to the rapid advancements and innovative financial solutions brought forth by FinTechs. This growing ecosystem paves the way for exponential innovation and a multitude of business opportunities, benefiting both traditional banks and other financial institutions. Without open banking, banks would face substantial expenses in establishing full in-house development teams to achieve comparable offerings.

2. Banking Through Collaboration

Instead of engaging in cutthroat competition for specialised skills and resources, traditional banks can partner with relevant FinTech companies, a strategic move to access expertise without extensive hiring. These partnerships accelerate innovation, leading to improved services and stronger customer relationships. This, in turn, enhances their ability to attract new customers and retain existing ones. What was once a competitive rivalry between traditional banks and FinTech companies has evolved into a symbiotic relationship, where partnerships are key to customer engagement and retention. Many banks are forming partnerships with global FinTech companies to enhance their services. With over 26,000 FinTech startups worldwide as of 2023 and continued growth in the FinTech sector, these collaborative ventures are expected to rise. Forward-thinking traditional banks that embrace such collaborations gain a competitive advantage and exponentially increase their potential to align with emerging, user-centric solutions.

3. Customer-centric experience

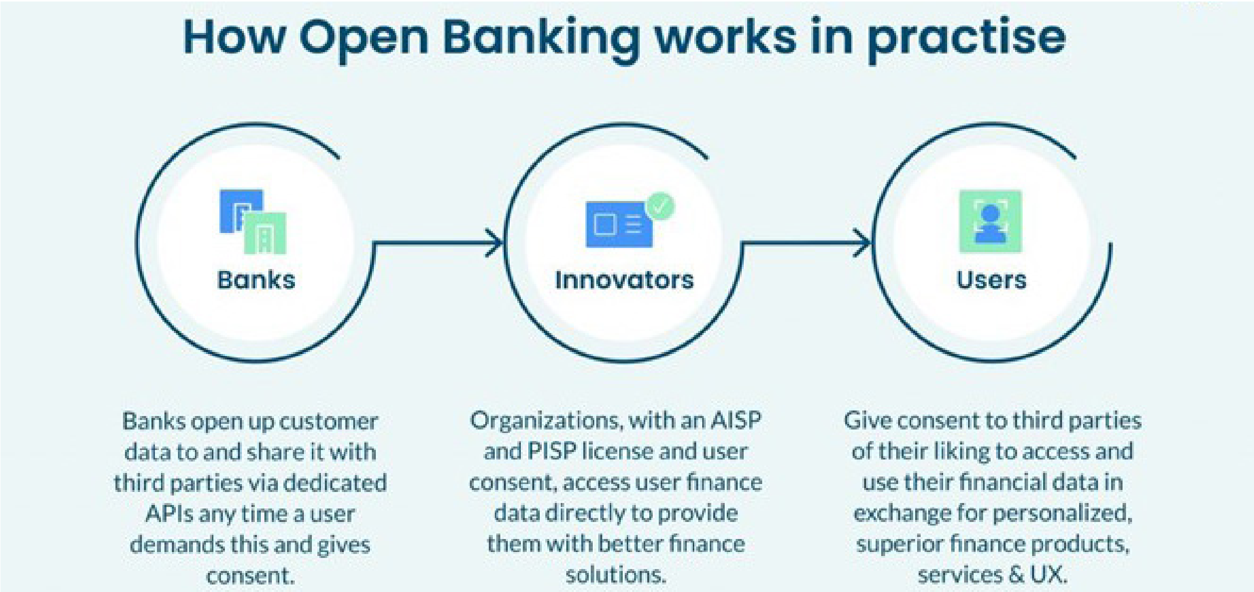
Open banking benefits banks by placing the customer at the centre. Competition, when channelled positively, drives innovation in the financial sector, for instance, compelling traditional banks to create engaging mobile applications and enhance online banking platforms. A more accessible and user-friendly experience not only encourages increased customer interaction and retention rates but also aids banks in maintaining their market share. This is a great chance for banks to strengthen a key factor in customer loyalty: trust. Through open banking, banks gain a comprehensive view of a customer's financial health, habits, and preferences. Leveraging this valuable intelligence allows for personalised communication with customers, focusing on fostering loyalty and cross-selling financial solutions tailored to each customer's unique preferences and needs. For instance, traditional banks could provide a customized weekly newsletter for each client, delivering insights on innovative products and solutions based on their specific preferences, or featuring success stories of customers who achieved financial prosperity through the bank's guidance.

4. Optimized data-guided decision-making

Open banking translates to improved data-driven decision-making. By opening relevant financial data to third parties, informed decision-making is enhanced not only for external entities but also for banks themselves. Through the integration of Artificial Intelligence (AI), open banking facilitates precise customer targeting based on historical data, behavioural patterns, and crowdsourced data analysis. This transformative approach enables banks to optimize their business operations, including interest rates, cash management, loan approvals, and risk assessments, all while effectively reducing operational costs. Additionally, open banking has the potential to simplify compliance processes and decrease associated costs. Anticipated advancements in Know Your Customer (KYC) and Anti Money Laundering (AML) protocols, facilitated by shared data capabilities, suggest a collaborative approach among service providers, sharing the responsibility and cost burden of compliance, with banks serving as primary data custodians.

Conclusion

In conclusion, the potential benefits of open banking for traditional banks are simply too great to overlook. This transformative approach allows for enhanced services and innovation, facilitated access to expertise through strategic partnerships, the ability to offer a customer-centric experience, and optimized data-guided decision-making. Recognizing that financial data rightfully belongs to the customers who generate it, the shift towards allowing customers to open their data to third parties is only a natural and essential step in this new era of collaborative and consumer-centric finance.



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