Open Banking: Ushering in Winds of Change in SME Banking

Abstract

Small and medium enterprises (SME) are the backbone of many large economies in the world with a direct contribution to economic growth and job creation in developed nations. The SME segment represents 99% of all businesses in the European Union (EU) and has created around 85% of the new jobs in the past five years.[1]

The world is witnessing the rise of start-ups and small businesses like never before and, a significant market opportunity is in the making for financial-service providers. Driving the trend are Gen Y and millennials who have demonstrated an entrepreneurial nature with a higher appetite for risk compared with the previous generations. This paper discusses the ways banks can collaborate with fintechs and capitalize on the opportunities created by the Open Banking regulation to drive growth and transformation in SME banking.

The Age of the Startups

The Open Banking regulation in the EU and the UK has triggered banks to expose accounts, statements and associated details (standing instructions, direct debits etc.) as application programming interface (APIs) to approved third party providers (TPPs) with a robust consent management system empowering customers to control sharing of their financial data. The specification requires business account data also to be exposed as APIs in addition to business products offered by the bank. In addition to exposing APIs, banks are registering themselves as third-party providers in the UK and the EU to consume other banks' APIs.

Fintechs have been quick to grab the opportunities created by the PSD2 and open banking regulations. They have actively shaped the market by launching a plethora of offerings aimed at addressing the financial needs of the next generation SMEs. Going forward, building upon the existing SME on-boarding processes, technology-led relationship manager experiences or traditional credit management methods and policies will not be adequate for banks to harness the opportunities created by these regulations. In our view, banks must position themselves as business partners to SME players rather than financial service providers. Digital user interfaces built using artificial intelligence (AI) can empower banks to actively participate in SMEs' business, deliver service contextualized to SMEs, ensure high levels of efficiency, and optimize operational costs.

Let's examine a few ways the banks can position themselves as partners of the SME segment.

Mentoring to build trust

SMEs' expectations from banks today are not just restricted to financial services through digital interfaces. They also expect banks to mentor them and actively participate in their business by offering advice and suggestions on business growth. Consequently, some large global banks are offering business advantage platforms tailored to meet SME needs across invoice management, payroll management, supply chain management and so on. However, these digital offerings are provided as value-added services usually in partnership with accounting software providers.

In our view, banks must not restrict themselves to value-added services but also build a comprehensive suite of digital offerings for SMEs by leveraging open banking. Banks must utilize open banking APIs to access financial and business operational data for the SMEs and provide a holistic view of their financial position. Open banking provides a unique opportunity for banks to offer digital services to prospective businesses even before they become customers by obtaining their consent (open banking consent management). This allows banks to digitally identify prospects, on-board them seamlessly by leveraging innovative offerings from fintech startups such as Trulioo, EZMCOM Inc. and, sell products based on their needs. This has the effect of essentially inverting the traditional banking on-boarding funnel from identify prospect → sell product → on-board for digital banking, to identify prospect → on-board for digital banking → contextually sell products.

Once on-boarded, we believe banks must leverage digital twin technology to help individual SMEs monitor business performance across multiple channels (desktop, mobile browser, mobile app, tablets and wearables). This will help banks gain contextual insights on individual SMEs and deliver compelling digital experience making mass personalization a reality in the SME space.

Additionally, the banks must consider building a digital platform using AI technologies to deliver digital services. The digital platform must be underpinned by strong data and analytics framework that leverages machine learning (ML) technologies to continuously measure the financial health of the business and proactively notify SMEs of hitches, such as delay in invoice payment or shipment of supplies that can potentially hinder smooth business operations. Combining digital twin technology with AI will empower banks to predict upcoming macro- and micro-level market conditions that affect SMEs' business. This will help build trust with the bank following which, the banks can contextually position their own SME banking products and services and significantly improve conversions.

Financing through connected supply chain platforms

Digitalization of supply chains has created digital trade platforms that allow SMEs to not only effectively manage supply chain concerns but also establish new digital links through the platform. Supply chain platforms such as SAP's Ariba Network, Tradeshift, Tungsten Network, and Taulia help SMEs seamlessly and accurately plan and predict their supply chains bringing SMEs on par with large corporations across the globe. These supply chain platforms offer application programming interfaces (APIs) that banks can consume to leverage thriving digital ecosystems. Banks can digitally evaluate trades occurring on the platform through AI-driven credit models in near real-time and offer trade financing products and services contextualized to the parties involved in the trade. Some platforms allow integration of their products and services into banks' SME platforms, which can subsequently be exposed to SME customers through apps. Some early movers who have taken advantage of this include HSBC[2] and Santander.[3]

Replacing credit risk with business health

Most banks still employ manual credit evaluation processes for SME lending, which reduces the profit margin on small loans making them unviable. The use of standardized credit models across micro, small and medium enterprises results in classification of many small businesses and start-ups as sub-prime candidates. In addition, some skewed notions, like 'younger customers have higher propensity to default,' have made it into lending policies and have affected outreach and profitability. All these factors have been responsible for large sections of SMEs being underserved by the banking system. Alternate lenders or fintechs have stepped into the gap and leveraged AI-powered credit models to drive SME lending thereby creating a new market for themselves. Fintech startups have lent billions of dollars to SMEs across the world earning significant revenues.

To capitalize on the SME business opportunity, banks must focus on making SMEs profitable and creditworthy instead of assessing creditworthiness. Comprehensive models must be developed to leverage open banking APIs to access SMEs' financial and business operational data and assess their business health. Financial health models must incorporate explainable AI models with the capability to provide insights on the parameters that affect the health of SME businesses empowering banks to nurture and improve business health. Millennials expect transparency from their banks and are motivated by rewards. Transparent financial health models allow banks to not only capitalize on lending opportunities but also reward SMEs when they improve and maintain their business health. Such comprehensive models can also serve as early warning systems when SMEs make incorrect business decisions or fail to take advantage of available opportunities thereby enabling banks to better manage credit risk. An innovation driven start-up culture is driving the next generation of SME customers and giving rise to new business models, which will come with a certain element of risk. To successfully serve this segment, banks will also need to adopt new ways of conducting business such as using AI-powered credit models to embrace the risk introduced by these new business models.

Creating prosperous SME communities to drive nation building

SMEs contribute significantly to the GDP of nations and generate substantial employment. Several nations have introduced financial products to promote SME growth. The US Small Business Administration's SBA 504 loans, the Micro Units Development and Refinance Agency Bank (MUDRA) launched by the Indian government to cater to SME lending, and the European Commission's EU-backed small business loans are some examples of credit products offered by government agencies to SMEs.

While governments use the banking system as the distribution mechanism for such products, they are not actively promoted by banks. Regulators must mandate exposing APIs for government products so that third-party providers can position them alongside regular bank products. Government agencies must incentivise banks to expose APIs for government products as well as TPPs to actively position these products to SME customers. Finally, government agencies must become active members of the open banking community by exposing and consuming APIs to drive the creation and seamless distribution of SME-friendly products and services.

The Way Forward

With fierce competition in the retail and corporate banking segments, the underserved SME segment represents a huge opportunity for banks. The banks must grab this opportunity and leverage open banking to introduce compelling digital offerings exclusively for the SME segment rather than adding digital fixes to existing retail offerings. There may be challenges in achieving this outcome and the way forward may lie in partnering with a vendor who can not only co-create propositions but help banks leverage the startup ecosystem and accelerate go–to-market for their offerings. However, care should be taken to choose the right partner after an evaluation of organization-specific requirements and a well-rounded market analysis.

References

1] European Commission, Entrepreneurship and Small and medium-sized enterprises (SMEs), Accessed Oct 2019, https://ec.europa.eu/growth/smes_en

2] HSBC, HSBC and Tradeshift join forces to revolutionise working capital financing, March 2017, accessed Sep 2019, https://www.hsbc.com/media/media-releases/2017/hsbc-tradeshift-announcement-final

3] Santander, Santander and Tradeshift partner to improve speed and simplicity in supply chain finance, July 2017, accessed Sep 2019, https://www.santander.com/csgs/Satellite/CFWCSancomQP01/es_ES/Corporativo/Sala-de-comunicacion/2017/07/11/Santander-and-Tradeshift-partner-to-improve-speed-and-simplicity-in-supply-chain-finance.html?leng=en_GB

About The Author

Prathap Thompson

Prathap Thompson is a Chief Architect in the Open Banking Strategic Initiatives group within TCS' Banking, Financial Services and Insurance (BFSI) business unit. He has more than 18 years of experience with expertise in open banking compliance, API economy, and next generation digital propositions. Prathap is also an intrapreneur designing next gen digital propositions as part of a small digital native team operating as a start-up within TCS. He holds a bachelor's degree in Manufacturing Engineering from the College of Engineering, Guindy, Anna University, Chennai, India.