Open Banking: Reshaping the Lending Landscape

Abstract

Financial institutions are increasingly leveraging digital technologies to improve customer experience and expand market share. However, inadequate information on the customer context limits banks' ability to offer personalized service in real time. The Open Banking Standard, which mandates opening up access to banks' customer account information through application programing interfaces (APIs) or open banking APIs, will help overcome this limitation. This paper discusses the impact of the Open Banking regulation on the lending space and its potential to reshape the ecosystem.

Breaking Ground with Open Banking

Financial institutions have traditionally relied on internal data and credit scores for credit risk assessment. However, this does not give a complete picture as it does not consider prospective borrowers' assets, liabilities, deposits, investments, and transactions across all financial institutions. Regulatory frameworks such as the Open Banking Standard[1] and PSD 2 that envisage providing third parties access to bank-held customer account information will help address this lacuna (see Figure 1). By enabling a holistic view of customers' financial position and analytics to gain insights, these regulations will help drive informed credit decisions.

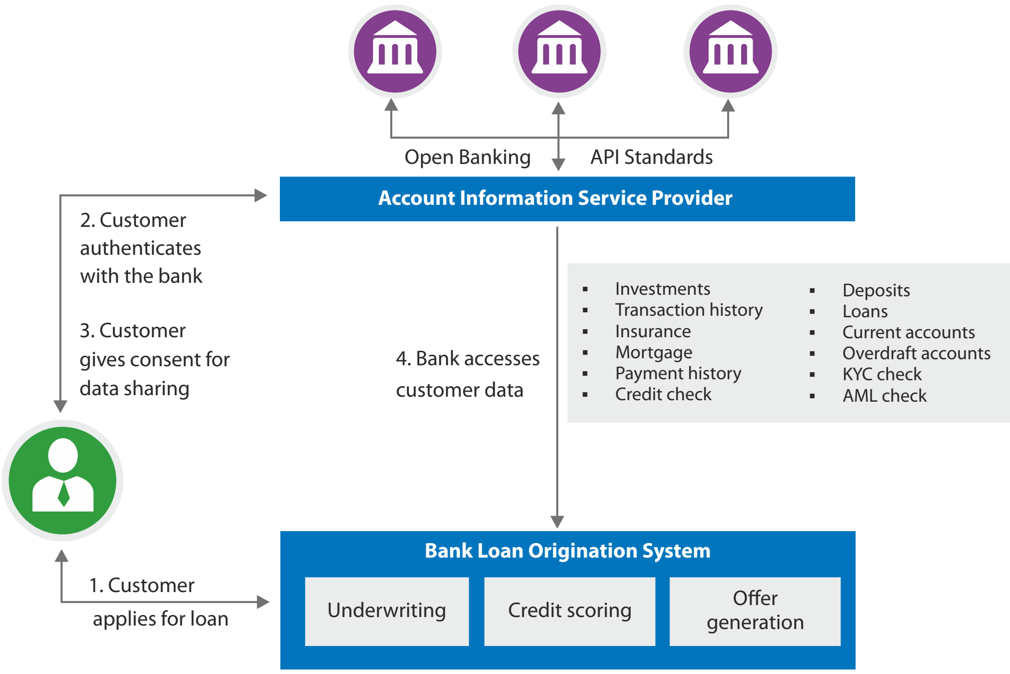

Figure 1: Customer Information Sharing as Envisaged by Open Banking

Open banking envisages banks using APIs to securely share customer data residing on their internal systems with third parties after obtaining customers' consent (see Figure 1). When a customer applies for a loan, the bank uses the open banking API to obtain information from all his bank relationships. Subsequently, analytics is performed on the consolidated information to derive insights that can improve decision-making. The entire process of gathering information is automated and occurs in real time. In fact, credit decisioning too can be automated, depending on the loan size and the risk appetite of the bank.

Reinventing Customer Journey with Open Banking Solutions

Open banking will facilitate the development of innovative lending offerings and eventually facilitate a move toward a more customer-centric business model. Customers today don't just expect service when they approach banks, but rather hope for proactive identification of their needs and tailored products that will work best, given their personal context. By enabling banks to step in at the right moment with the right offer based on a real-time view into the customer context gleaned from financial data, open banking can help take customer experience to the next level. For example, based on details of payments to a travel agent from an external account, the bank can proactively offer the customer a vacation loan or a line of credit. Such contextual offers will contribute to customer delight and play an important role in winning (and, maintaining) customer loyalty.

Similarly, SMEs face liquidity crunch and longer processing times due to lack of financial data for the banks to process. A window into SME customers' banking transactions can reveal information about sales figures, cash flow patterns, business expenses, investments, and so on. Open banking will provide banks the access to SME customer financial information across banks, thus paving the way for banks to reimagine the SME customer journey.

Default prevention

With open banking, banks can monitor the financial health of customers by tracking transactions across all their accounts. This can help prevent default by providing early warnings to banks' internal control teams and enabling better collection management. For example, a steady fall in balance over time could signal a decline in financial standing and the need to reassess the customer's credit risk profile. An alert can be triggered for the bank to reach out to the customer to try and understand the reason behind the decline in financial standing. Open banking can enable banks to improve collections by tracking funds inflow into accounts and triggering alerts when customers miss repayments.

Ensuring a Seamless Adoption

Individual banks must draw up a strategy to adopt open banking depending on their size, structure, market position, business strategy, and operating model. A SWOT analysis of different business lines will help banks identify areas where open banking adoption will create additional revenue streams. Such an analysis will also help banks decide on the approach for adoption; for example, whether to target a specific customer segment or all segments. This will be a key factor in determining the investment, resources, and technology expertise required for execution. Banks must evaluate the service provider landscape and choose the right technology partner for a smooth implementation and quick return on investment (RoI). While there is no one-size-fits-all approach, we propose a conceptual design for integrating open banking into banks' lending function along with the initiatives that can be adopted.

Figure 2 depicts the conceptual design of a system that uses data from external service providers, external data sources, data from multiple channels such as mobiles and social media, along with data from internal systems within a bank which is then acted upon by different functional components for reimaging the customer journey. Encapsulating the various systems in a wrapper solution enables the bank to leverage the open banking model irrespective of the age of the application. By having API driven communication across layers, banks have the freedom to leverage analytics and artificial intelligence (AI) to adapt to fast-changing customer requirements and market competition.

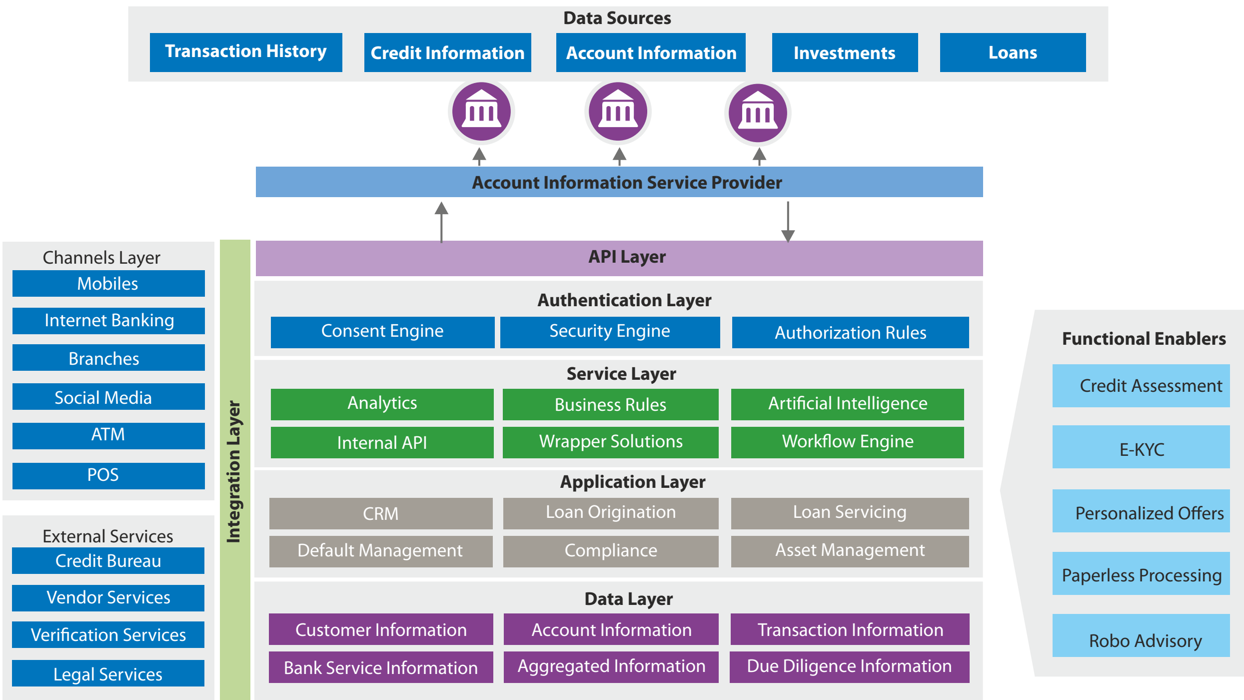

Figure 2: Open Banking Architecture Integrated with the Lending Business

Open Banking Enablers

While the Open Banking regulation came into effect in the UK on January 13, 2018, the adoption remains optional in other geographies such as Singapore, Germany, and South Korea. Despite the absence of a regulatory mandate, a few financial institutions have taken the lead in adoption[2,3,] but a majority remain cautious due to the increased compliance and implementation costs. Moreover, banks are wary of sharing customer information as it can lead to loss of market share if the competition offers better service and innovative products. However, given the regulatory push for data sharing and open banking, adoption may become mandatory soon. Before embarking on a full-fledged adoption, banks must undertake some preliminary steps to facilitate trouble-free implementation:

- Adopt Agile methodologies to ensure faster time-to-market for products and services. Quickly launching innovative pilot products will help banks test the waters and make timely alterations based on market feedback to arrive at the best product design and the right delivery model.
- Reorient IT architecture to enable an API strategy and open banking APIs to facilitate seamless data integration and improve processing time. Banks must put in place API wrappers and integration tools that sit on top of legacy systems and enable exposing their data to third parties.
- Adopt an analytics framework to derive valuable insights from customer information. Customer insights form the foundation of personalized banking experiences. A comprehensive analytics framework can help banks identify ways to drive value by facilitating their application in various lending segments.
- Create a dedicated regulatory compliance team to tackle regulatory change management. Given the comprehensive nature of the regulation, a dedicated team can help define a clear roadmap for compliance while enforcing controls, especially with regard to costs.
- Implement stringent audit measures to ensure the security of customer data while sharing with third parties and other banks. Robust access and authorization mechanisms must be established to ensure that the data does not fall into the wrong hands.

What Lies Ahead?

Fintech companies have struggled to gain insights about customers, and have often resorted to screen scraping and other complex methods. But with open banking, they will gain access to customer information like never before. FinTechs will be quick to leverage this advantage and introduce innovative lending products to grab market share from incumbents, thereby setting the stage for the next wave of disruption in lending. Looking at the Open Banking regulation as a mere compliance exercise would be short-sighted and leave banks vulnerable to stiff competition. Incumbent banks must leverage the 'Open Banking' opportunity to redefine the customer journey if they are to retain their market position.

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