>> WHOSE CUSTOMER ARE YOU? THE REALITY OF DIGITAL BANKING IN EUROPE//

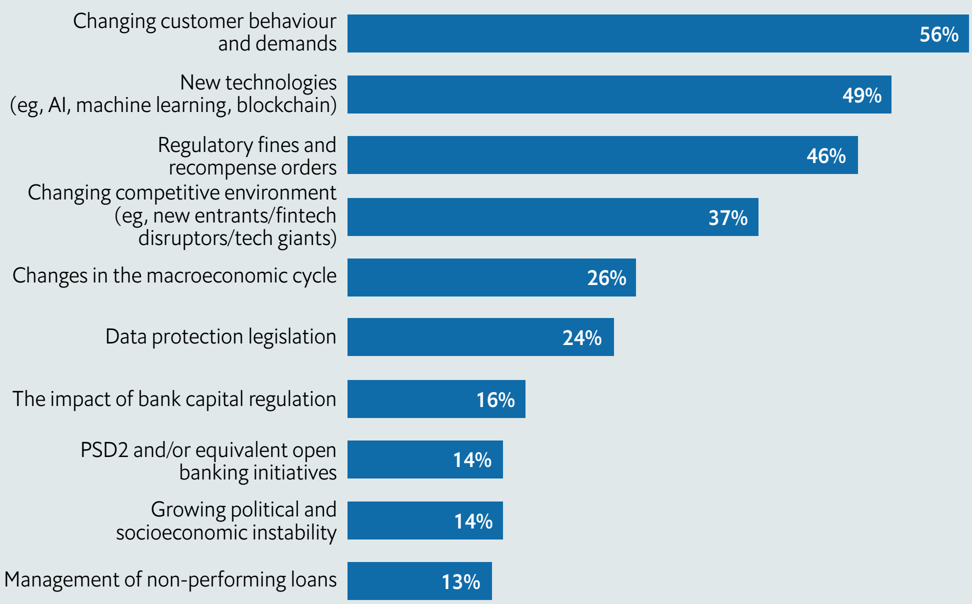
Europe's open banking experiment is finally under way. Security and engagement are vital.

Europeans spent May 2018 dealing with email pleas from companies begging them to stay friends. Thanks to the General Data Protection Regulation (GDPR), over half a billion EU citizens now wield more power over who holds data on them and what companies can do with that valuable information.

At the same time, the second Payment Services Directive (PSD2) is making its presence felt. It aims to encourage competition by allowing non-bank players to access customer bank account information and to initiate payments.

Chart 1

Which trends will have the biggest impact on retail banks in your country in the years to 2020?
(% of respondents)



Source: The Economist Intelligence Unit.

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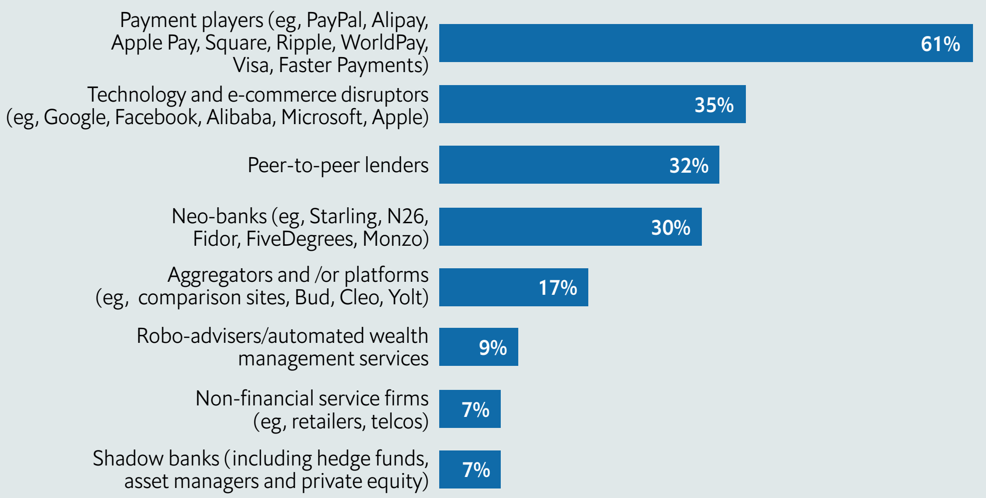
According to an Economist Intelligence Unit survey, the European banking industry remains remarkably relaxed about the upheaval. Data protection was cited by only 24% of respondents as one of the trends that will have the biggest impact on the industry over the next few years.

European bankers are far more concerned about changing customer behaviour, with 56% of respondents identifying it as the top trend to impact retail banks. Bankers are far less concerned that new entrants will gain a foothold via PSD2 (cited by only 14% of European bankers). However, bankers do feel the threat from payment players including PayPal and Apple Pay, as 61% think these will be their biggest rivals by 2020, aided by disruptive tech and e-commerce giants, cited by 35% of respondents.

Chart 2

Which non-traditional entrants to the retail banking industry will be your company's biggest competition in the years to 2020?

(% of respondents)



Source: The Economist Intelligence Unit.

Navigating the digital revolution

The European banking market is highly developed. In the Eurozone area, 95% of adults have accounts, 87% already have debit cards and 69% used the internet to pay bills or buy online in the past year.[1] Much of the migration from branch to online, and from cash to card, has already taken place or is in the process of this. Migrating client usage to digital from physical channels is the top priority for 42% of European bankers. The bankers are now focused on finessing the interaction between personal contact, online and mobile.

[1] Global Findex, World Bank, https://globalfindex.worldbank.org/

THE TEST-BED FOR INNOVATION: HOW STANDALONE DIGITAL BANK BRANDS FACILITATE THE TRANSFER OF BIG IDEAS.

Santander's standalone online Openbank launched in 1995. A recent organisational and technology overhaul has allowed it to rethink its delivery, products and service from scratch.

A new technology stack will allow for the full automation of back-office functions, says CEO Ezequiel Szafir Holcman.

Openbank now runs entirely on the cloud, reducing operational costs and capital requirements. New products and features can be added more quickly. Customer on-boarding is smoother too; credit takes two mobile phone clicks to approve.

"We are 100% artificial intelligence based; we do not use old-fashioned, rule-based algorithms. The result is a much fairer credit risk decision-making process," says Mr Szafir.

Despite having over 1m clients, the bank has no physical presence. For those uncomfortable with a pure digital experience, Openbank staff will visit a customer's home to complete paperwork.

"At Openbank we do not believe in 'app only' banking services as most of our competitors in the 'digital attackers' segment seem to be doing," says Mr Szafir.

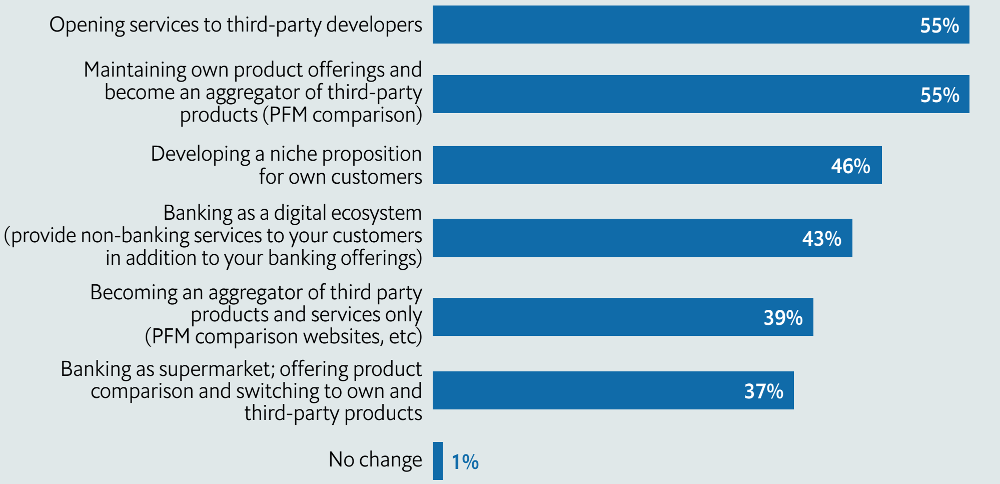
His bank has 135 full-time employees. Everything learned by the team about technology and customer behaviour is shared with the "big bank", adds Mr Szafir.

Convincing customers to go completely digital may be tougher than in previous banking innovation cycles. Digital wallets and robo-advice may not induce the same feelings of freedom as Barclays' ATMs did in 1967, or Nottingham Building Society's Homelink online service in 1983.

PSD2 open banking requirements weigh on strategic priorities too. European bankers know their mobile apps may not be niche propositions, with only 46% seeking to develop a niche proposition for their customers versus 61% globally. This may be because open banking will allow third-party apps to offer the same features. This may account for why 55% of European bankers are opening services to third-party developers.

Chart 3

Strategy: How do you see your current business model evolving?
(% of respondents)



Source: The Economist Intelligence Unit.

BUILD YOUR MARKETPLACE WISELY

The Economist Intelligence Unit survey showed that European bankers are the keenest investors in fintech start-ups with 63% citing it as their innovation strategy versus 53% globally. However, they should be careful which alliances they form.

One new fintech start-up working with British banks is Wealthify. It aims to democratise investing with simple low-cost long-term savings options. The service was recently added to the mobile marketplace of UK challenger bank Starling. It now sits alongside travel insurance, a pension aggregator, a mortgage broker and another robo-adviser, Wealthsimple.

Richard Theo, Wealthify's CEO, thinks banks must tread carefully when building out their mobile service offerings with in-house or external providers. They need to boost engagement through choice, but must avoid falling into the trap of heavily regulated investments.

"It is imprudent to offer everything to everybody. Banks want to offer the best in breed, but must provide choice to avoid being seen to advise in the direction of a single product," he says.

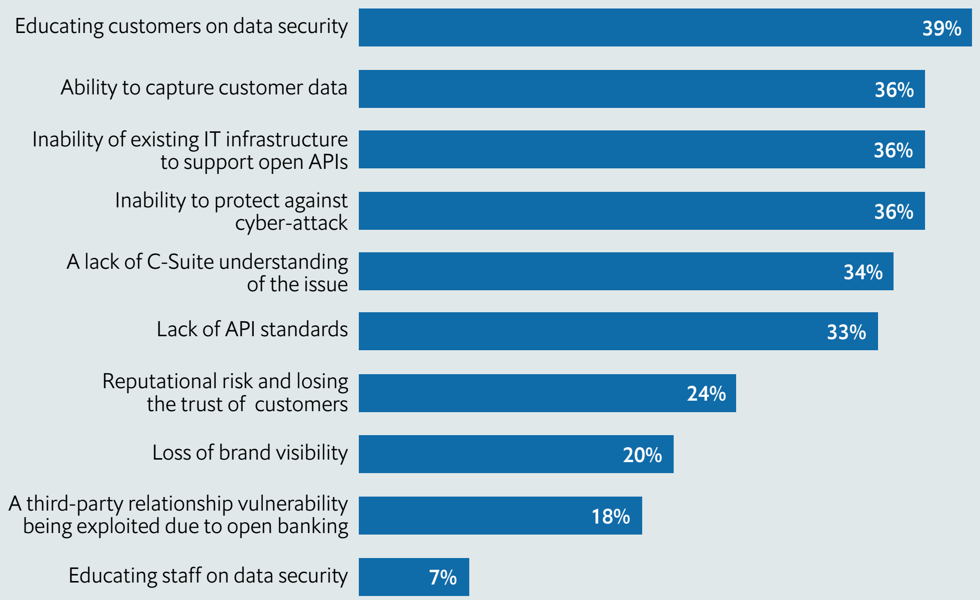
Mr Theo believes that the strategies of large banks are well advanced, with internal solutions or partnerships, along the lines of the established European bancassurance model. Smaller and regional banks tend not to have their own insurance arms or adviser networks, so are more likely to look for external suppliers of investment solutions.

It remains to be seen if European customers will opt to aggregate all their banking, savings and investments in a single app. As Mr Theo points out: "People have many apps on their phones already. They are comfortable with choice."

He suggests that "disaggregation" may well occur if bank and fintech apps struggle to constantly offer the best in every product category. If that is the case, bank apps may have to settle on being a mere window on savings and investment relationships that consumers prefer to form directly.

Chart 4

What are your main concerns in relation to API Based Open Banking?
(% of respondents)



Source: The Economist Intelligence Unit.

To compensate for any losses from PSD2, it seems banks want to build in rich functionality to make their apps indispensable. To do this they are developing two different models: either becoming aggregators, as suggested by 39% of respondents, or maintaining their own product offerings and becoming an aggregator, a model pursued by 55% of respondents. If not, others may assimilate their customers, leaving banks as mere product manufacturers and suppliers of balance and transaction data.

But banks also need to be careful about who they partner with as they build their multi-service platforms on the back of payment functionality.

As noted in Chart 4, 36% of respondents believe that existing IT infrastructure needs upgrading. Nearly 40% also say customers need educating about data security as banks open up their data fortresses. Yet, The Economist Intelligence Unit survey revealed that only one in ten European bankers is concerned about who is liable if a third-party link goes wrong. PSD2 rules have yet to be tested in court.

The GDPR is clearer on the misuse of data. It imposes fines of up to 4% of global turnover for poor processing or transfer of customer data. No wonder banks are more concerned about reputational damage, cited by 24% of respondents as their main concern, after a serious cyber-attack occurs. But if internal and third-party vulnerabilities cannot be exploited, a primary concern for 18% of bankers, then nobody's reputation need suffer. What emerged as the absolute spending priority, agreed to by 81% of respondents, was spending on cyber-security.

Finding the niche in the value chain

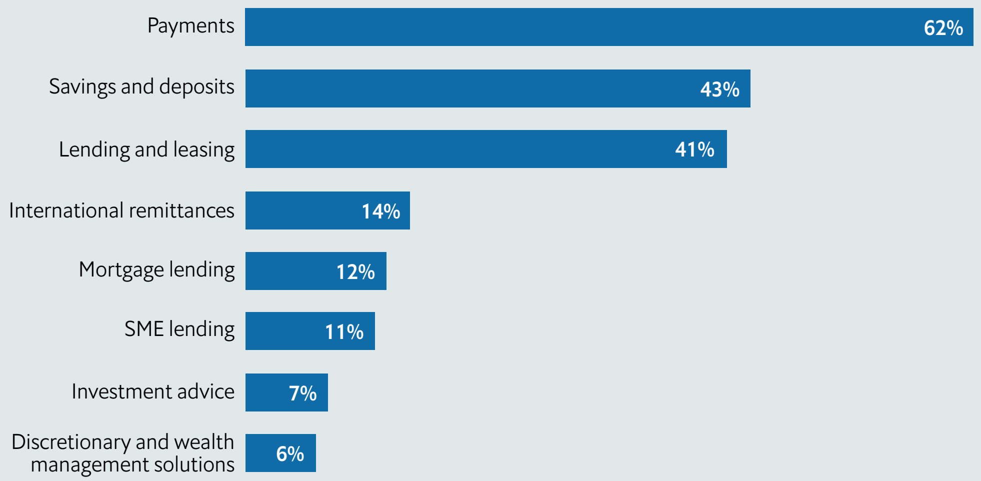
Transactions are not the only area facing disruption. Europe's bankers are also slightly more concerned than their global counterparts about the rise of peer-to-peer (P2P) lenders, with 32% citing this as a concern versus 28% globally.

Overall P2P lending totals remain small relative to the bank industry's loan book, and are highly concentrated in the UK. Funding Circle is planning a £300m listing[2] in London.

P2P and marketplace lenders (who facilitate financing from corporate investors) may yet find a real niche across Europe. The likes of Lendix, a French online-lending marketplace, provide a useful lifeline to businesses needing capital. These developments help explains why 41% of respondents saw lending and leasing as the main area for new entrants to gain market share and 11% saw small and medium-size enterprise (SME) lending as a growing area for new entrants.

Chart 5

What is the main area where you expect new entrants to gain the most market share?
(% of respondents)



Source: The Economist Intelligence Unit.

Indeed, the race is on to add scale and functionality to convince small businesses to swap their trust in banks to fintechs that may actually lend them the money they need. New players, such as Modulr, a digital payment service, provide an alternative to company bank accounts, allowing accounts departments to automate payment processes such as payroll and accounts payable.

"Fintechs and platform providers such as accounting software are our obvious market and they can integrate quickly. We also see interest from smaller banks and building societies who want flexibility, cost efficiency and functionality, but that takes time," says Modulr's CEO, Myles Stephenson.

[2] Bloomberg, September 3rd 2018, https://www.bloomberg.com/news/articles/2018-09-03/funding-circle-plans-to-proceed-with-initial-public-offering

Useful, safe and definitely not dull

Will a heavy security focus be enough to ward off the challengers and the neo-banks that piggyback off the licences of others?

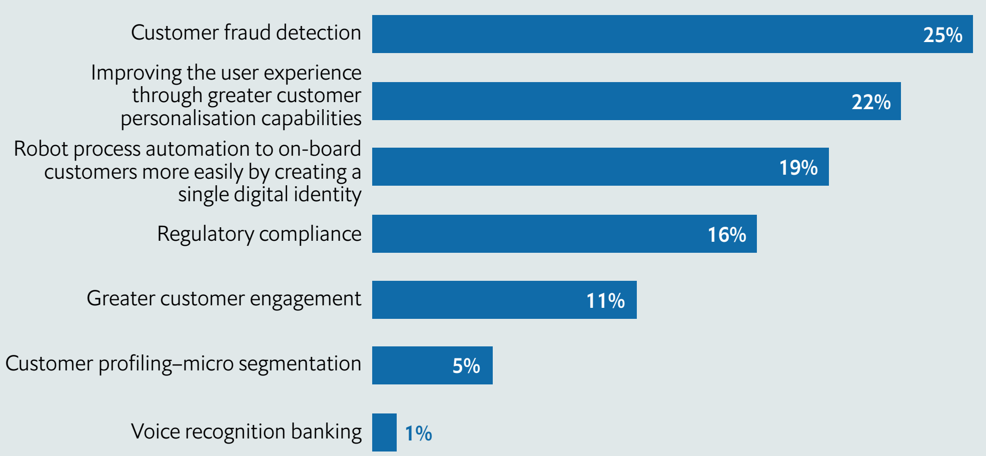
If all digital offers can provide similar functionalities, banks will have to work hard on making theirs the most useful.

To do so, European banks need to get smarter about using data, not just ensuring it is safe. Although 45% of respondents are focusing their investment on improving performance and scalability through cloud-based technologies, the data amassed needs to be used intelligently. Unfortunately, just 10% of respondents are making digital investment in advanced and predictive analytics a priority investment.

The same trends can be seen in the use of artificial intelligence (AI). As noted in Chart 6, European bankers focus primarily on AI's fraud detection capabilities (25%). Even though 22% think AI can be used to improve the user experience from a front office perspective, only 11% see the value-add in customer engagement and only 1% in voice recognition. That may reflect the industry's continued emphasis on sales, which has led to customer dissatisfaction, mis-selling and multimillion-euro fines in the past.

Chart 6

What do you believe will be the most valuable use of Artificial Intelligence for retail banks?
(% of respondents)



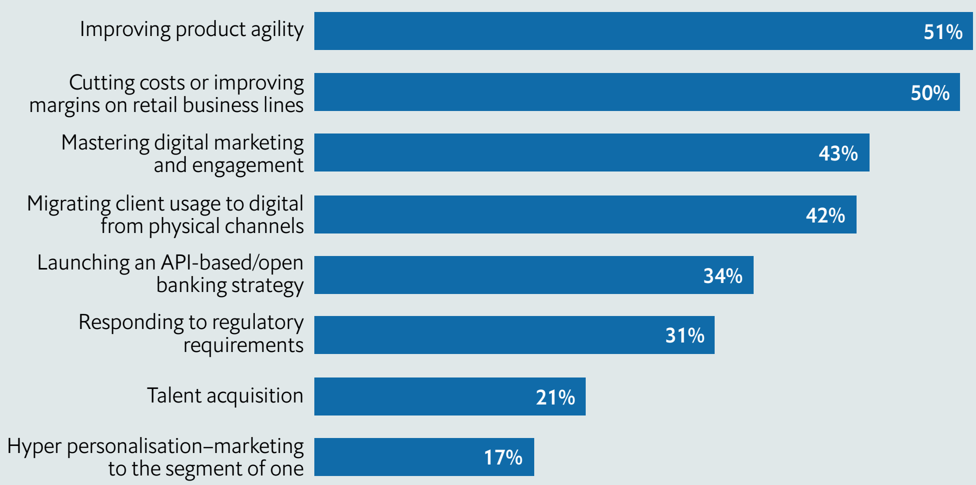
Source: The Economist Intelligence Unit.

Creating the wow-factor

To complete the digital transition, bankers need to work on their digital engagement (as cited by 43% of respondents as a strategic priority). Most importantly, they need to improve response times to new features introduced by agile newcomers; improving product agility was the top strategic priority cited by 51% of survey participants. Both objectives can require heavy investment at a time when there is a strong focus on cutting costs, as noted by 50% of respondents. However, these investments should be considered necessary given the need to meet changing consumer demands and to fight off competition from new entrants.

Chart 7

What are the top strategic priorities for your company in the years to 2020?
(% of respondents)



Source: The Economist Intelligence Unit.

Meanwhile, banks can still be competitive. An example is that of Spanish banks that have shared the cost of developing Bizum, a new payment-to-mobile function available within each bank's app. It has attracted 1.5m users in one year, a good start in a country still wedded to cash. In-store and online payments are next, potentially giving the adherent banks a solid base to galvanise customer engagement.

Spanish and other banks have also deployed new technologies to remove friction from lending decisions and other processes. But Konsta Hanssen of tech consultancy Reaktor believes there is more to be done.

"Technology helps make lending quicker and gives more access to credit, but the AI used is not very high functioning," he says.

More data would allow more complex functionality and analysis, of course.

"WeChat had chat first; payments came second. Alipay had its shopfront, then it added finance," warns Mr Hanssen.

Mr Hanssen points to Finnish oil company ST1 as an example. Its financial arm is not alone in offering instant approvals on its credit card. Its customers can use their cards immediately too within Apple Pay. Not having to wait for the physical card to arrive by post offers instant and retained customer engagement.

Banks are unlikely to match the depth of behavioural data held by Google or the Chinese tech giants. But they certainly can use what they have more effectively.