20 June 2022

The future of technology laggards in banking is increasingly clouded. Banks that fall behind in adjusting their structures and operations to the emerging digital-first ecosystem will find it increasingly hard to remain competitive and profitable. Even before the digital age, post-crisis Europe was burdened with excess banking capacity. Digitalisation is making this situation worse, even if Open Banking and its subsets – Banking-as-a-Service (BaaS), Banking-as-a-Platform (BaaP) and Embedded Finance – are not purposely designed to bypass banks.

What these new digital services are designed to do is to push banks towards the new transparent, open and interactive world. For clarity, I exclude here Decentralised Finance (DeFi), a general term used in the crypto environment for decentralised applications (dApps) that provide financial services on a blockchain settlement layer and rely on open-source protocols and smart contracts[1].

The digital challenge for banks is no longer about adjusting traditional products and services to the digital age to preserve existing customer relationships. Digitising the customer front end is yesterday's challenge; banks have been doing that for some time. Online banking has been the main avenue; the pandemic significantly speeding up transition for bank customers and employees.

The challenge ahead is about repositioning incumbent banks as players in the new ecosystem to compete for customers' financial needs and data with other participants; banks and non-banks alike. It is also about replacing more traditional delivery and decision-making channels with APIs, and of migrating back offices and data storage to the cloud.

In the EU, Open Banking was made possible by the revised Payment Services Directive (PSD2), which came into force in 2018. Unlike prudential legislation on capital requirements (CRD IV/CRR), which was enacted as a reaction to the global financial crisis, PSD2 is a progressive regulation, repositioning the European banking sector for the future, pushing open new doors, focusing on payments and customer data transparency. This regulation is increasingly being replicated in other regions of the world.

Going back to basics, banking relies on three core elements: customers, products, and delivery. Banks in the EU enjoy a very high

[1] DeFi is more present in the US than in Europe. Blockchain technology is likely to become more widely utilised by financial institutions and markets but the future of DeFi itself is more uncertain, especially in the absence of suited regulations.

degree of penetration among the adult population: 90%-99% in Western and Northern Europe. This is unlike other regions of the world, including the US, where close to 23% of households are un-banked or under-banked.

This means there is less room in Europe for fintechs and neobanks to capture large segments of new customers not served by incumbent banks and, importantly, do it profitably. As has been the case in other parts of the world with large segments of unbanked populations: China, Africa, or Latin America.

Fintechs and neobanks do not have legacy costs like incumbent banks so can provide products and services at lower cost. In recent years, many large banks in Europe have gotten their digital act together and have been able to compete on the cost front as well either directly or via digital-bank subsidiaries or both (even if the latter may end up cannibalising some customers of the parent legacy bank). Better keep clients within the group than lose them to competitors.

All this means that the new world of Open Banking, BaaS/BaaP, and Embedded Finance should be welcomed and embraced by incumbent banks that are technologically well equipped; not feared or shunned. At the end of last year there were roughly 1,500 third-party providers (TPPs) in Europe – especially account information service providers (AISPs) but payment initiation service providers (PISPs) too – established following the adoption of PSD2.

Over 1,200 TPPs are existing financial intermediaries – many of them banks. But more than 300 TPPs have been established de novo.

History is written by the winners. There are many stories of banks successfully adapting to the new ecosystem of Open Banking and BaaS: banks like ING, BBVA, Nordea, Société Générale, and NatWest. Smaller institutions with commoditised and undiversified franchises and lagging digitally are not seen or heard from.

Investors and analysts should in my view become more inquisitive in their dialogue with banks about their strategies and involvement with Open Banking and Embedded Finance. It is an area that can no longer be ignored.

Pressure on profits and business models

Despite a rising number of banks embracing the platform-based open system, a major unknown will be the impact on profitability. Transparency, openness, and accentuated customer-centricity inherently minimise the built-in profit cushion of privileged financial intermediation. In other words, if incumbent banks aim to lower the delivery costs of their products to match the new digital-native competitors, as they should, their bottom lines may suffer. At least until they can readjust their overall expense structure. Because, unlike fintechs, banks remain burdened by high legacy costs – physical branches and off-the-cloud back offices.

But there are clear revenue opportunities in the early adoption of the Open-Banking environment, for example from BaaS/BaaP-related fees and commissions. Beyond that, partnering with non-financial businesses can broaden a bank's footprint and place customer relationship on a trajectory better adapted to the new dynamics.

The emergence of an open financial ecosystem raises questions about the future of universal banking as a viable business model. If, at the latest a generation away, the future of banking lies in open-platform transactions providing customers with transparency around price and choice, the implicit cross-selling advantages of a universal bank and preserving some activities as loss leaders, will be more difficult to justify.

This raises questions about the economic rationale of M&A between large universal banks with substantial legacy structures, especially cross border where synergies are less easily attainable. Management efforts and resources are much better dedicated to expanding and diversifying in the digital space.

In my view, the reported intention of BNP Paribas, already the largest Euro Area bank by assets, to acquire ABN AMRO from the Dutch State fits the description of an unconvincing move in the legacy-bank space.

Open Banking, Baas/BaaP, Embedded Finance: adding partnerning to intermediation

Open Banking as a concept and business model is at its first stage, focusing primarily on customers sharing their banking data with AISPs and initiating payments directly via PISPs, bypassing more traditional channels such as cards and bank transfers. If more products and services are included, such as lending/borrowing and savings, and open banking can hopefully evolve towards open finance to include non-banking services like insurance and investments.

The most advanced market for Open Banking in Europe is the UK, reportedly with almost four million users. Large UK banks are part of the process. The system benefited from early standardisation guided from the start by the Competition and Markets Authority. This is not yet the case in the EU. In fact, alongside customers' inherent fears about data privacy, a major barrier to faster growth of Open Banking in Europe has been lack of standardisation. Notably for APIs, which are the essential nodes, the seamless interface among customers, banks and TPPs.

The open banking model is now starting to move beyond its first stage, with BaaS, BaaP, and embedding financial services into the offers of non-financial brands to their customers.

Under BaaS, regulated banks allow their core services (mainly those that are highly commoditised) to be used by non-financial external parties in their value chain. Under BaaP, banks operate as hosts, allowing TPPs to provide their own products and services to hosting banks' customers. These two business models are part of Embedded Finance, where non-financial players offer financial products to their clients while adhering to technological functionality and regulatory and licencing requirements.

While PSD2 is the most progressive regulation in this area, BaaS, BaaP, and Embedded Finance are more developed in the US than in the EU – with the UK being somewhere in between. Several forward-looking regional and community banks in the US are using BaaS (sometimes nicknamed "lend a charter") to boost revenues and attract new customers. The *sine qua non* is having the right technology in place.

Growth opportunities in this area are almost limitless in Europe. There are millions of SMEs, many of which can represent potential partners and customers in the new ecosystem. Once, that is, the barrier of mistrust is taken care of and proper API standardisation is adopted to enable seamless integration across the continent.

Based on what banks themselves communicate, it seems that it is mostly the larger groups that have been making inroads. But it is also an area that smaller banks can and should also engage in. The key to success is the right technology, more than just size and product diversification. For Embedded Finance partnering, plain-vanilla and low-risk financial products are easiest to integrate and understand. More sophisticated and riskier products, such as derivatives, would be less suitable and may be frowned upon by regulators.

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Scope SE & Co. KGaA

Lennéstraße 5
10785 Berlin
info@scopegroup.com

Scope Ratings GmbH
Lennéstraße 5
D-10785 Berlin
info@scoperatings.com

Scope Ratings UK Limited
52 Grosvenor Gardens
London SW1W 0AU
info@scoperatings.com

Scope ESG Analysis GmbH
Lennéstraße 5
D-10785 Berlin
esg@scopegroup.eu

Scope Analysis GmbH
Lennéstraße 5
D-10785 Berlin
info@scopeanalysis.com

Scope Investor Services GmbH
Lennéstraße 5
D-10785 Berlin
info@scopeinvestors.com

Scope Hamburg GmbH
Stadthausbrücke 5
D-20355 Hamburg
info@scopehamburg.com

www.scopegroup.com
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