E. European Impact

European open banking regulations: do they really favor innovation? Evidence from a cross-regional comparison between Asia and Europe

ESCP Impact Paper No. 2022-19-EN

Mathilde GUILHON

ESCP Business School & Square Research Center

ESCP RESEARCH INSTITUTE OF MANAGEMENT (ERIM)

ESCP
BUSINESS SCHOOL

ESCP Impact Paper No.2022-19-EN

European open banking regulations: do they really favor innovation? Evidence from a cross-regional comparison between Asia and Europe

Matilde Guilhon*

ESCP Business School & Square Research Center

Abstract

The Open Banking concept emerged in Europe with the implementation of the PSD2 EU directives in 2013. A similar ruling was issued in the UK by the Competition Market Authority in 2016. These regulations were designed to promote innovation in banking services by opening the sector to new entrants (e.g., Fintechs, start-ups) and providing third parties with access to banks' customer data and functionalities. In this way, data sharing and market entries were supposed to increase competition and drive innovation towards new value propositions for banking customers.

However, the European banking sector is struggling in its transition towards Open Banking models. In Asia, where the Open Banking concept emerged later, the banking sector is nonetheless experiencing significant transformation thanks to greater intensity and a faster pace of innovation. One of the main reasons for these cross-regional differences lies in the regulations. In this impact paper, we analyze Open Banking regulations in Europe and Asia to explain differences in the cross-regional performance of banking service innovation.

Keywords: Innovation, Regulations, Open Banking,

*Ph.D. Student, ESCP Business School

European Open Banking regulations: do they really favor innovation? Evidence from a cross-regional comparison between Asia and Europe

Introduction

Open Banking is characterized by major regulatory reforms and competitive structure reconfigurations, with new entrants offering novel value propositions through innovative business models. It is a banking system where individual and corporate clients authorize their banks or financial service providers to use their financial data via APIs (Application Programming Interfaces). Open APIs enable third parties (developers) to access and exploit financial data to create new services and financial solutions. The underlying idea is to guarantee better financial transparency for account holders (Wewege & al., 2019), to promote competition in the retail banking sector and to enhance clients' experience. Open Banking regulations were initially introduced to promote innovation in the banking sector. Together with regulatory mutations and technological changes, the emergence of open business models represents a significant change in values and practices, paving the way for a new paradigm in the retail banking sector (Omarini, 2018).

However, the European banking sector is struggling in its transition towards Open Banking models. In Asia, where the Open Banking concept emerged later, the banking sector is nonetheless experiencing significant transformation thanks to its greater intensity and pace of innovation. One of the main reasons for such cross-regional differences lies in the regulations. In this impact paper, we analyze Open Banking regulations in Europe and Asia to explain differences in the cross-regional performance of innovation in banking services.

What can European regulatory institutions and banking executives learn from Open Banking initiatives in Asia? How can they enhance innovation in the European banking sector?

While acknowledging cultural, political, and economic characteristics between and within these two regions, the aim of our paper is twofold. First, we take stock of Open Banking initiatives in Europe and Asia by examining their regulatory and commercial underpinnings. Second, we analyze banking incumbents' responses to such evolutions. The paper examines differences in Open Banking regulatory approaches in Asia and Europe to draw lessons that can help promote innovation in the European banking sector.

Open Banking Regulations in Europe

Digital and technological advances have resulted in major changes in the way individuals share their personal data, search for products and services, and buy and consume them. However, for many years, few regulations addressed data-based and digital business interactions, giving rise to considerable security issues for individuals. In the banking system, where compliance regulations were reinforced following the 2008 crisis, European regulators took the lead to protect bank consumers in the digital age and to guarantee financial stability. Second, while, for many years, the European banking system suffered from inertia from the customers' perspective, European regulators also attempted to provide greater impetus for banking system innovation (Wewege et al., 2019). Their principal objective was to "invite the financial services industry to embrace the potential of new technologies by introducing legal certainty to previously unregulated services" (Omarini, 2022: 138).

The revised Payment Service Directive (PSD2) was adopted in 2015 and came into force in 2018. Its main goal was to transform the European banking landscape into a more open and innovative sector. It included several objectives: establishing banking and payment service standards across the European Union (EU), opening up the banking sector to novel entrants to enhance competition, and reinforcing security for banking customers in a context of digitalization. From a technical perspective, PSD2 exhorts incumbent banks to provide application programming interfaces (APIs) to third-party providers (TPPs), such as financial start-ups, Fintechs, technology firms, and banks, in order to share data upon customers' consent.

In the EU, Open Banking guidelines and recommendations are issued by the European Banking Authority (EBA). Another piece of legislation, the General Data Protection Regulation (GDPR), was introduced in 2018 to protect consumer data in the context of digitalization. Together with PSD2, GDPR contributes to the development of regulatory guidelines that serve as building blocks for Open Banking in the EU (Omarini, 2022). As for the United Kingdom, the Competition and Markets Authority (CMA) has published several recommendations following the logic of PSD2 directives to establish Open Banking standards regarding data sharing and APIs (Zachariadis & Ozcan, 2017). Both the CMA and the European Commission pursued the objective of unbundling banking services and opening up the banking sector to create "a more level playing field" through the implementation of novel regulations (Ozcan & Zachariadis, 2021: 2).

However, implementation of Open Banking in Europe has stalled for several years, and incumbent banks have found it difficult to take advantage of the new environment and to innovate.

Open Banking in Asia: towards a market-driven approach

A 2018 Accenture survey[1] indicates that almost 75% of European banks and 60% of banks across Asia Pacific were planning to introduce Open Banking initiatives. What are the drivers of these initiatives in Asia? South-East Asian countries are well advanced in terms of Open Banking. While the driver of Open Banking in Europe is mainly regulatory, the motivation in most Asian countries is largely commercial.

The most extreme illustration is China, where regulators have not enforced any legislation or limited BigTechs such as Alibaba and Tencent in their attempt to expand into financial services. These giant platforms have been able to create super-apps that operate as fully-fledged ecosystems, offering their users financial and extra-financial solutions. For instance, Alibaba offers multiple services in its WeChat Pay app, encompassing mobile payments, online banking, a BtoB marketplace, a monetary fund, wealth management services, social scoring, fractioned payment, and consumption credit.

In countries where banking systems are closer to European ones, such as Hong Kong and Singapore, regulations exist, but they are less constraining than PSD2 and those of CMA, and are mainly motivated by market development factors. The Hong Kong Monetary Authority (HKMA) decided not to define standards for data exchange, for instance. Leaving this option to large incumbents, HKMA introduced the Fintech Supervisory Sandbox, enabling banks and Fintechs to share their data and to conduct pilot innovation projects. In addition, based on consultation with incumbent banks, and learning from Open Banking

[1] Accenture (2018). *Accenture Open Banking for Businesses Survey 2018 – It's Now Open Banking.*

initiatives conducted abroad, HKMA launched an industry-wide Open API Framework that involves four phases of development. HKMA has thus adopted a more progressive approach to Open Banking regulations than European regulators.

In Singapore, the government backs Open Banking initiatives by providing API or Banking-as-a-Service reports as well as a list of APIs available in the financial industry. Although these guidelines are not compulsory, Singapore's banks have been very dynamic in terms of data exchange through APIs. For instance, DBS developed the world's biggest banking API platform, with over 200 APIs addressing 21 categories, such as cards, loans, online payments, and sales opportunities.

A similar approach was adopted in Japan. The Japanese government supports innovation through the entry of Fintechs and aims to promote competition by providing standards and a regulatory sandbox for Open APIs. In 2018, for instance, the Banking Act was amended to establish open API architecture and promote exchange between banks and Fintechs.

Our paper distinguishes between the legislation-based Open Banking model, adopted by countries or groups of countries such as the UK or the EU, and a market-driven Open Banking model. In the first model, it is mandatory for banks to open their data to third party providers upon customers' agreement. In the second model, which corresponds to a liberal approach, regulators leave the field relatively open for Open banking initiatives to connect different actors, i.e., financial institutions, Big Techs, developers, Fintechs, and firms belonging to non-financial sectors. In the legislation-based model, Open Banking corresponds to an imposed innovation, where pressure from non-market stakeholders (i.e., European regulators) is high, while the economic incentives to implement this innovation are relatively low (Radnejad & Osiyevskyy, 2019). In the aforementioned Asian countries, the incentive to engage in Open Banking is associated with high expectations in terms of competitiveness and profitability.

What lessons can we learn from regulatory differences between Asia and Europe?

Contrary to other sectors where regulators set the rules after new technologies and innovation have emerged, Open Banking regulations in Europe have preceded innovation, leading to several challenges for existing actors.

On the one hand, since they are ill-adapted to the reality of the context, Open Banking regulations lack clarity and precision in addressing key issues such as legal liability in collaborative arrangements between banks and third parties (Ozcan & Zachariadis, 2021). The pan-European regulations failed to take national specificities sufficiently into account. Although such regulations were designed to provide consistent standards at European level, their lack of clarity together with the characteristics of national banking systems resulted in diverse types of implementation and limited success. Inadequate adaptation to national financial landscapes, for instance, led some countries, such as France, Germany, and the UK, to delay implementation of the PSD2.

On the other hand, regulators' discourse aimed at boosting innovation and competition in the retail banking industry by putting pressure on dominant positions. In other words, the aim of the regulators was not to frame and set standards for an industry where incumbents compete with new entrants, but instead to explicitly encourage these new actors by promoting their innovative offers and setting them against traditional banking services. Regulators thus adopted a hard standpoint with regard to traditional banking. Together with technological innovations and the emergence of digital consumption, these regulations contributed to the shift from a supplier-oriented retail banking system dominated by incumbent retail banks to a market-oriented banking sector where incumbents' positions are increasingly contested (Omarini, 2022).

When the regulations were first adopted, Open Banking was perceived by incumbents as a threat more than an opportunity to create a competitive advantage. Radnejad and Osiyevskyy (2019) noted that the ability of incumbents to develop an effective response to an imposed innovation strongly depends on the perception of the innovation as either a threat to the entire industry or as an opportunity to create a competitive advantage. Incumbent banks perceived the threat clearly but lacked a vision of the potential competitive advantage they could generate in this context. This led incumbents from the very beginning to adopt a an attitude of defiance towards Fintechs and start-ups, rather than explore the opportunities for collaboration. For instance, figures on external operations (e.g., partnerships, equity investment, acquisitions, and joint ventures) between traditional French banks and Fintechs show that the number of operations gradually increased between 2013 and 2019 (Coeurderoy & Guilhon, 2022).

Our analysis of the regulatory differences observed between Asia and Europe enables us to determine four major limitations of European Open Banking regulations from an incumbent perspective.

First, the cumbersome and ambiguous guidelines provided by the European Commission and the CMA explain the limited results of Open Banking regulations in Europe. Almost three years passed between the adoption of PSD2 and its implementation. During these years, traditional banks spent a great deal of time deciphering the burdensome regulations and attempting to comply with them rather than developing an appropriate innovation strategy. Incumbents' hesitation towards their future value creation models and the herding effects observed in the external operations they conduct illustrate this observation (Coeurderoy & Guilhon, 2022).

Second, complying with regulations preceding the innovation itself is difficult and costly given the yoke of a complex IT legacy in incumbent firms, and the considerable time pressure imposed by the regulators. Historically, banks' technological infrastructure was designed to operate in isolation. Opening up these siloed infrastructures as technology evolves forces incumbent banks to deconstruct a system built up over decades.

Third, since they perceive novel entrants more as a threat than an opportunity, European banks cannot take full advantage of the Open Banking environment. Successful positioning could be achieved by integrating Fintech-style options with banks' existing products. The Singaporean bank, DBS, has gone one step further by collaborating with Microsoft on a Global Hackhathon, a model for developing next generation Fintech solutions based on the Microsoft Azure platform. The project provided a unique opportunity for talent and product development, and for collaboration between a bank and a BigTech.

Fourth, in addition to the Open Banking regulations, antitrust regulations are particularly stringent in Europe, discouraging initiatives like those taken by DBS which has developed strong ties with dominant players in other activity sectors, such as electricity and mobility. Such collaboration in Europe could be difficult to achieve as banks must abide by antitrust regulations, restricting them from creating such conglomerates.

Conclusion

It is true that regulations represent a catalyst for Open Banking. However, market factors such as consumer habits, competition, and technology, are equally important drivers of innovation in the context of Open Banking. Nevertheless, our analysis of regulatory differences between Asia and Europe provides evidence that in the case of strict compulsory regulations, banks passively attempt to comply with imposed innovations without appropriating them or viewing them as an opportunity.

From the clients' perspective, what is happening today in the European banking sector is not very satisfying since incumbent banks struggle to develop a customer-centered approach as interesting as those offered by platforms. Moreover, regulations that open up industries with higher consumer inertia to competition might inadvertently favor BigTechs, thereby recreating a monopolistic situation in the long term (Ozcan & Zachariadis, 2021). BigTechs have no interest in aggressively entering highly regulated financial markets. However, this does not mean that strict regulations effectively discourage them from expanding into financial services. BigTechs are likely to move forward in disguise on the fringes of regulations.

In this respect, we advocate for greater coordination between regulators so they can provide a fruitful environment in which incumbents can innovate. We also encourage Open Banking regulations to adopt a more progressive and market-driven approach in Europe. Obviously, the aim is not to maintain a dominant position at the expense of consumers. However, in our view, with their decades of experience in data security and expertise in financial services, incumbent banks must remain at the centre of the financial system in order to ensure its stability and to guarantee consumer protection.

References

Coeurderoy, R., Guilhon, M. (2022). "Dancing in the dark": incumbents' evolution towards new value creation models in the process of banking platformization, ESCP Working Paper, April 2022.

D'Addezio, M., Berard, T., Coeurderoy, R. Rolland, F. (2020). May established banks benefit from a reputation effects with users?, *Banque & Stratégie*, 397, 39-42.

Diamond, S., Drury, N., Lipp, A., Marshall, A., Ramamurthy, S., Wagle, L. (2019). The future of banking in the platform economy, *Strategy & Leadership*, 47(6): 34-42.

Omarini, A. (2018). "Banks and Fintechs: How to Develop a Digital Open Banking Approach for the Bank's Future", *International Business Research*, 11(9): 23-36.

Omarini, A. (2022). The Changing Landscape of Retail Banking and the Future of Digital Banking. In M. Heckel & F. Waldenberger (Éds.), *The Future of Financial Systems in the Digital Age* (p. 133-158). Springer Singapore.

Ozcan, P., Zachariadis, M. (2021). Open Banking as a Catalyst for Industry Transformation: Lessons Learned from Implementing PSD2 in Europe. SWIFT Institute Working Paper, July 2021.

Parker, G. G., Alstyne, M. W. V., & Choudary, S. P. (2016). *Platform Revolution: How Networked Markets Are Transforming the Economy—and How to Make Them Work for You*. W. W. Norton & Company.

Radnejad, A. B., & Osiyevskyy, O. (2020). Navigating imposed innovation : A decision-making framework. *Business Horizons*, 63(1), 97-107.

Wewege, L., Lee, J., Thomsett, M. C. (2020). "Disruption and Digital Banking Trends", *Journal of Applied Finance & Banking,* 10(6): 15-56.

Zachariadis, M., Ozcan, P. (2017). The API Economy and Digital Transformation in Financial Services: the Case of Open Banking. SWIFT Institute Working Paper, June 2017.