ECONOMIST IMPACT

Challenging the challengers: Europe's banks face the competition

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Scrappy fintech firms and neobanks took the lead in using new technologies to provide better customer experiences, reach underserved markets and offer a greener alternative to traditional banking services. Now Europe's traditional banks are fighting back.

- New research from Economist Impact, supported by Temenos, finds that European banks are more likely than those in other regions to expect neobanks to be their company's biggest competitors in the next five years. However, payment players and technology providers continue to be top of mind, with payments being the space in which European banks predict that new entrants will gain the most market share.
- Europe's banks are meeting the competition head-on by building greenfield digital banks, creating super-apps or ecosystems, and providing "banking as a service" offerings to brands and fintech firms.
- European banks are investing in technology such as AI and augmented and virtual reality to improve the customer experience, but over one in five also see migrating to public cloud as a strategic priority to ensure that their operations are agile and secure.
- European banks are emulating the way that non-traditional players have used technology to reach consumers who had been underserved by traditional financial services, and to appeal to existing customers with support in managing their personal finances. However, they could do more to offer "green" products to appeal to consumers concerned about climate change.

ABOUT THIS RESEARCH

Economist Impact conducted a study, commissioned by Temenos, to understand emerging trends in the banking industry. This report presents insights from a global survey of 300 executives in retail, commercial and private banking spanning Europe (25%), North America (23%), Asia Pacific (18%), Middle East and Africa (17%), and Latin America (17%). Respondents perform various job functions spanning IT, customer service, finance, marketing and sales, strategy and business development, and general management, among others. Half of the respondents are C-suite executives. This is the seventh year that Economist Impact has conducted this survey. The research also included interviews with industry practitioners to gain further insights.

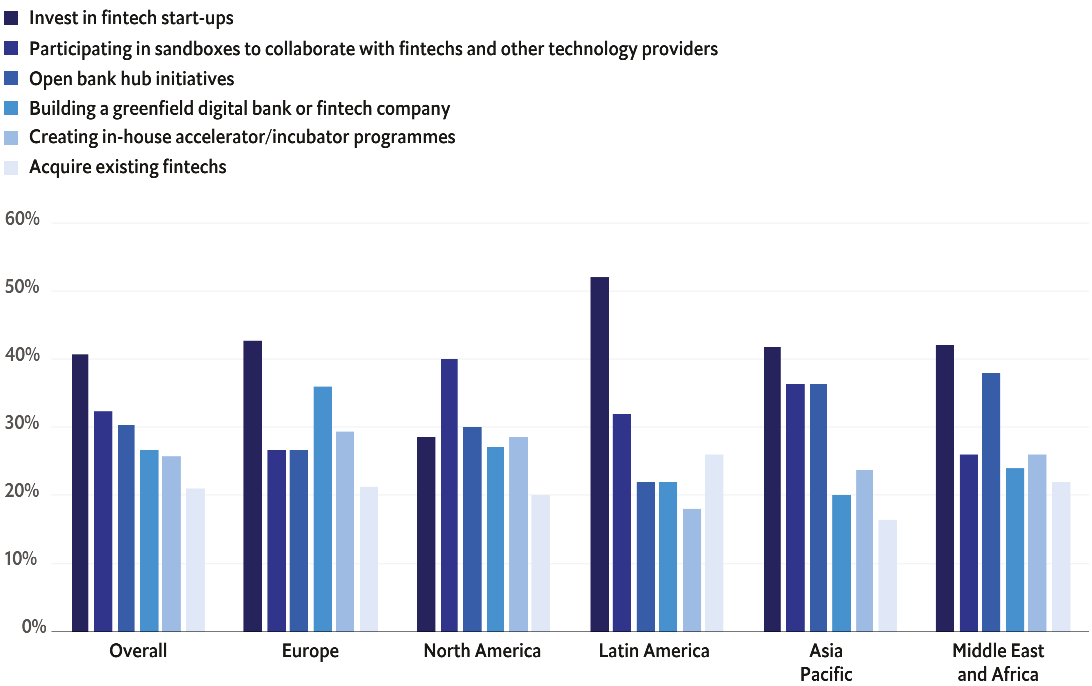
Challenging the challengers

Europe is home to some of the globe's most popular neobanks, with brands such as Monzo and Revolut in the UK and N26 in Germany having quickly gained market share and strong backing from big investors. In response, Europe's traditional banks have fought to retain customers and appeal to new consumer segments by launching their own digital-only subsidiaries, such as Openbank from Spain's Banco Santander and Hello Bank! from BNP Paribas (France). These have had mixed results, with some banks—the UK's RBS with Bo, and Raiffeisen Bank International (Austria) with ZUNO—winding down their digital offerings.

As traditional banks have sought to emulate the technology-enabled seamless customer experience of neobanks, challengers have become bogged down by more mundane issues as they have sought to become licensed banks. Revolut's application for a UK banking license has been held up since 2021 owing to concerns about its financial controls, workplace culture and staff turnover, reliance on crypto trading, and integrity of accounts. German financial regulator BaFin imposed a growth cap on N26 in response to organisational issues and poor anti-money laundering controls.[1]

With both sides facing challenges, the competitive landscape is shifting. Our survey found that just 21% of senior executives in European banks believe that challenger banks will flourish, and 35% expect that there will be market consolidation. In response, they are continuing to build their own greenfield digital banks or fintech companies at a higher level than banks in other regions (see Figure 1). But they are also exploring collaboration by investing in fintech start-ups, creating banking super-apps or ecosystems that bring in the offerings of fintech firms, and providing "banking as a service" offerings to fintech firms and other companies.

Figure 1: What is your bank's innovation strategy?



1 https://www.ft.com/content/a71140e3-f3e9-492d-9012-c5d578215944

The impact of Open Banking

This type of collaboration has in many ways been made possible by open banking. Europe has been at the forefront of open banking, pioneering the concept ten years ago and bringing it into force with the EU's Payment Services Directive (PSD) 2 and the UK's Open Banking Standard in 2018.

Now, as both the EU and the UK work on updating their open banking rules, our survey respondents in Europe are much more aware than their counterparts in other regions about the influence of the changing competitive environment. They are more likely to believe that shifting roles and fortunes of platform players, neobanks, payment providers and more will be the biggest impact on banks in their country in the next five years.

European banks are more likely than banks elsewhere to expect neobanks to be their company's biggest competitors in the next five years. However, payment players and technology providers continue to be top of mind, with payments the space that banks predict new entrants will gain the most market share (see Figure 2). This is an expectation born from experience. Electronic payments have soared in recent years, with the pandemic accelerating a long-term trend. In the EU, the volume of electronic payments hit €240trn in 2021 (US$262.3trn), compared with €184.2trn in 2017.[2] Also, fintech growth has been particularly strong in the payments sector, with 93 of the global sector's top 335 "unicorns" (private start-ups valued at over US$1bn) providing payment solutions.[3]

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One of those payment unicorns, Wise, was valued at US$11bn in a record London direct listing in 2021 and as of March 2023 had revenues of £846m (US$1.1bn). Its 16m customers use it to move more than £9bn (US$11.4bn) a month. However, Roisin Levine, head of UK and Europe partnerships at Wise, recognises that many people maintain a relationship with their bank while using Wise for international payments—and sees opportunity for greater collaboration to make this a smoother process.

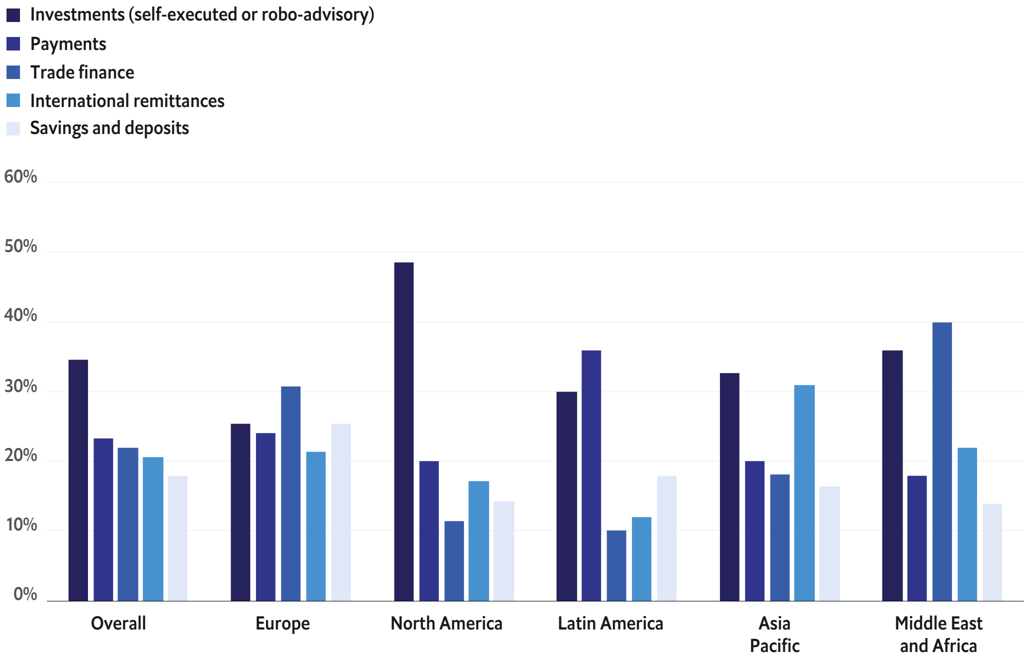
"We see people moving money from a traditional bank into a Wise account to make an international transfer, which adds an extra step," she says. "[It's] great that we have customers that want to use our service so much that they will do that. However, the best possible experience is where the product fits perfectly so you can make a payment from wherever you bank—getting all the good parts of a fintech experience, but within one environment."

European banks are acknowledging this as well. So while they are maintaining their own product offerings, they are also becoming aggregators of third-party banking and/or non-banking products, more so than banks in other regions (see Figure 3).

This is fuelling a rise in co-operation with fintech firms like Wise that have direct to consumer offerings, but also with "infrastructure players, B2B fintechs, who have a core offering that banks can plug and play, using a variety of different players for different offerings like payments," Ms Levine says.

2 https://www.altfi.com/article/psd3-the-european-union-unveils-new-open-banking-rules
3 https://www.eitdigital.eu/fileadmin/2023/ecosystem/downloads/makers-shapers/EIT-Digital_Fintech-Report.pdf

Figure 2: What is the main area where you expect new entrants to gain the most market share?



However, this collaboration rests on API-based interfaces and there have been functionality issues that have hindered the expansion of open banking. This is one area that the European Commission hopes to improve with PSD3, the new Financial Data Access (FIDA) rules and Payment Services Regulation (PSR). It launched its proposals in June 2023 and the finalised versions are expected by late 2024, meaning that after the usual 18-month transition period, new rules could take effect in 2026.[4]

Playing catch-up with technology

As banks and regulators have gained a better understanding of API functionality and the real-world implications of open banking, the EU is taking the next step by updating PSD2's Regulatory Technical Standards with the unveiling of PSD3.[5]

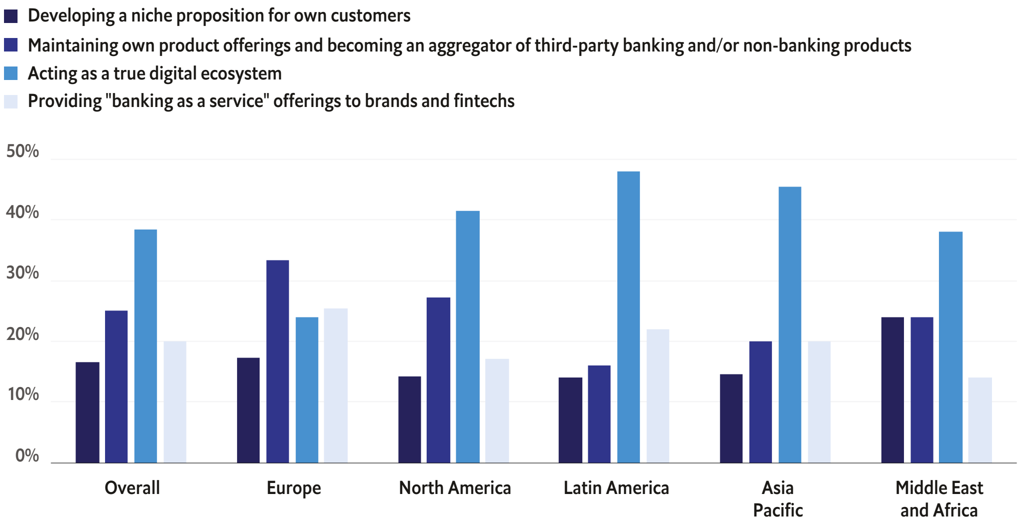
The goal is to drive innovation and modernise the financial services industry. Many traditional banks have struggled to stay abreast of emerging technologies and their potential uses and impacts. A recent report from White Case, a law firm, described banks as "museums of technology", and its survey found that one in eight European banks have lost 30-40% of their existing customers owing to poor customer experience. [6]

Our survey found European banks are catching up on digital experiences. They state that AI is a key part of their tech investment strategy, in particular to support digital marketing, and some are also investing in augmented and virtual reality to improve customer experience.

However, tech investment is broader than customer experience. European banks are migrating to public cloud services/software

4 https://www.adyen.com/knowledge-hub/psd3
5 https://fintechmagazine.com/articles/eu-unveils-psd3-proposals-the-next-level-of-open-banking
6 https://www.whitecase.com/insight-our-thinking/financial-ma-september-2023/fintech

Figure 3: What is the primary way in which you see your current business model evolving over the next 12-24 months?



as a service (cloud-based apps) in greater numbers than their counterparts in other regions. Over a fifth of European banks (21%) see tech investment as a strategic priority that will ensure their operations are agile and secure, allowing them to compete with more nimble competitors. Digital channels are the main focus of migration for European banks (see Figure 4).

Tech investment is taking many forms, and some banks are pursuing multiple strategies. French bank Société Générale is developing "home-grown" technology, with its launch of its EUR CoinVertible digital currency, as well as acquiring "plug and play" fintech offerings like Upvest, an investment platform. Other strategies are more collaborative. Santander and Deutsche Bank (Germany) have respectively formed partnerships with "distribution channel" fintech firms Two and Credi2, while Switzerland's UBS has established a fintech innovation ecosystem through a development joint venture. [7] Such collaborations are becoming more appealing to fintech firms as they struggle to garner investment amid a challenging economic climate.

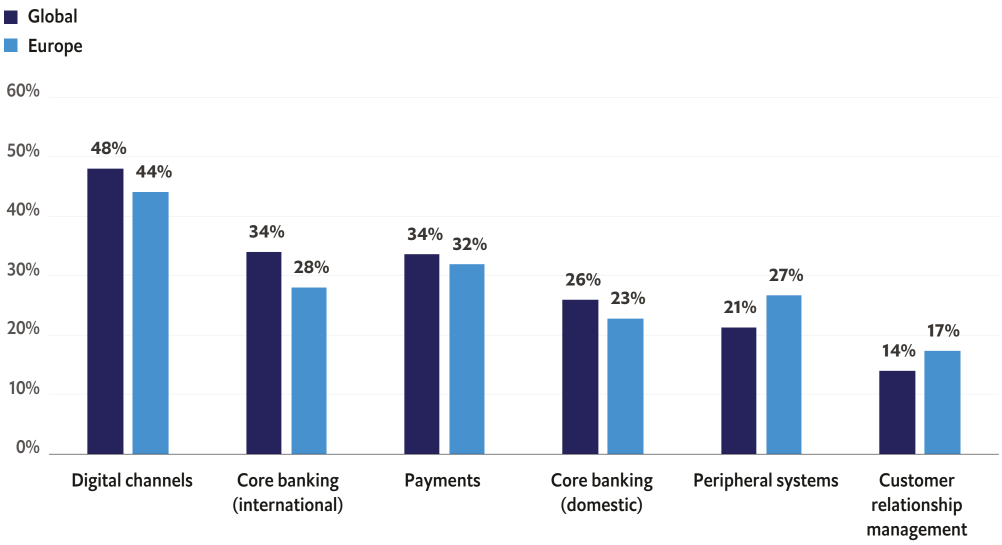
ESG and financial inclusion as a competitive advantage

European banks have seen how non-traditional players have used technology to appeal to existing customers with support in managing their personal finances. Banks are now including budgeting and personal finance management tools as part of their tech investments to improve the customer experience. These tools are particularly relevant now, as high inflation means that many people need support to manage steep increases in the cost of living.

Challengers have also used technology to offer financial services to "under-banked" or underserved consumers. Whereas this typically means offering bank accounts and lending to lower-income consumers, at Alpian, the focus has been on "democratising access to sophisticated investment offerings," according to the firm's former CEO, Schuyler Weiss.

7 https://www.whitecase.com/insight-our-thinking/financial-ma-september-2023/fintech

Figure 4: What type of applications do you believe that banks will prioritise in moving to the cloud over the next 12-24 months?



Banks are now turning to this space as well, with plans to offer responsible lending as a strategic, actionable business opportunity in the next one to three years. Not only does this expand their customer base, financial inclusion is also seen as one key area where banks can improve their ESG credentials.

Although the “S” of ESG (social) is gaining more attention, the “E” (environment) continues to be the focus for many Europeans, who are more concerned with climate change than people in other regions. Some non-traditional players have used this to appeal to consumers by creating “greener” operations and product offerings.

According to Ms Levine, Wise has been “carbon neutral since 2020, and we put out a longer-term commitment to be net-zero emissions. We committed to our largest purchase of high-tech carbon removals to date which will be active over the next decade, and we’ve obtained clean energy circuits in offices now.” The company is complementing its operational changes by offering its customers “eco-cards” made from a biodegradable material, rather than plastic.

The European banks surveyed are more concerned than their peers in other regions that ESG regulations will lower the financial profitability of banking sector. However, they could offset these costs by making the most of the opportunity presented by ESG to appeal to consumers—particularly those from younger generations—who increasingly expect climate action from their financial services providers. So far, European banks lag behind their peers in other regions in offering embedded ESG/sustainable banking propositions to their customers (see Figure 5).

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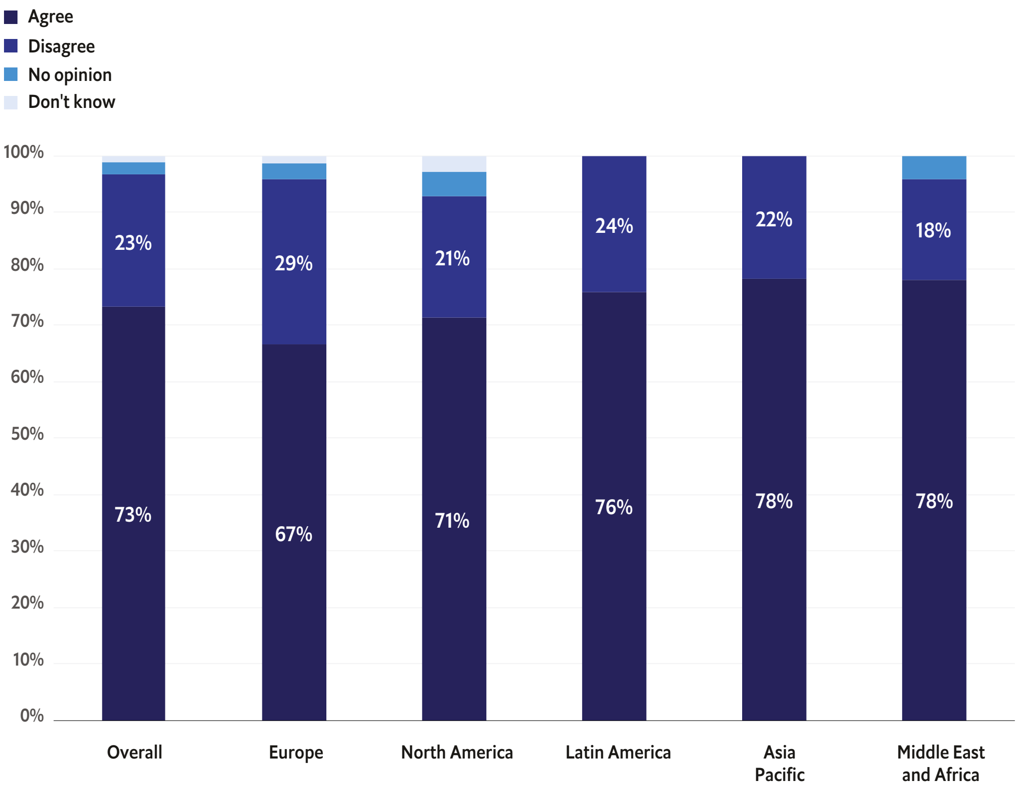
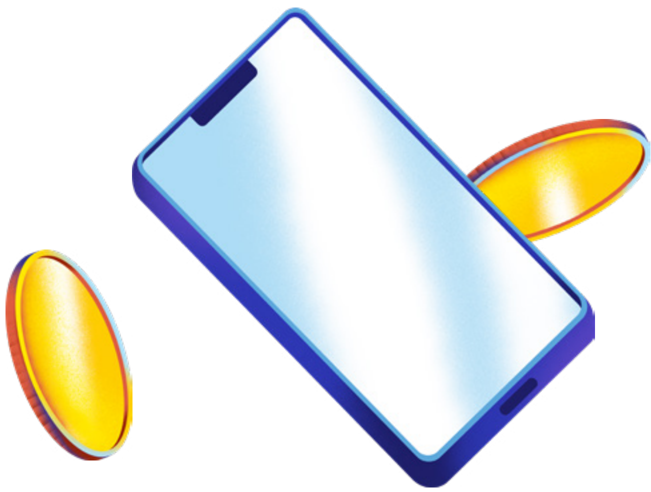
Figure 5: Banks will offer embedded ESG/sustainable banking propositions to their customers — both retail and enterprise



Adapting to a changing landscape

European banks are seizing the opportunity presented by a changing competitive environment. As neobanks and fintech firms experience growing pains and face funding difficulties, banks are taking advantage of the opportunities afforded by open banking by pursuing collaborations with their challengers to offer a wider range of improved services to their customers. They are also investing in technology to both improve the customer experience and ensure that their operations are agile and secure. Where they could do more is in grasping the opportunity presented by ESG to appeal to consumers who increasingly expect climate action from their bank.



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