Deloitte.

Open banking

Conduct: it's everyone's responsibility

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Open Banking is an 'opportunity to re-shape how banks will deliver value in their financial products'.[i] It promises substantial benefits in competition, innovation and productivity. In preparing for open banking organisations will need to address potential conduct considerations of fairness, transparency, vulnerability and suitability.

A new system

When implemented open banking will give customers a Consumer Data Right, allowing them to authorise their bank to share their transaction and balance information with third parties in the banking ecosystem.[ii]

The opening up of banking data, technology enabled innovation and changing customer preferences may facilitate competition from smaller and more agile fintechs, as well as new entrants from adjacent industries. This could lead to an uncoupling of banking products from distribution which would demand a fundamental rethink of the traditional banking business model.[iii] The implied shift from a product-centric to a customer-centric model may also blur industry boundaries, giving incumbent banks opportunities to serve adjacent consumer needs.[iv]

While open banking is intended to enhance competition and generate benefits for consumers, new technologies and blurring industry boundaries create the potential to introduce new conduct related issues.

In the past, both financial institutions and regulators have failed to keep up with the external environment, particularly changes in technology. They have often failed to anticipate events and only reacted to them.[v]

The Australian Securities and Investment Commission (ASIC) focuses on conduct risk through a fair outcome lens:

- Customers are treated fairly
- Financial products perform in the way that customers have been led to believe that they will
- Financial services firms have regard to consumers' behavioural biases and information imbalances.[vi]

Good conduct is everyone's business[vii]. In preparing for open banking organisations will need to address potential conduct considerations of fairness, transparency, vulnerability and suitability.

Notes

[i] Topfer, Luke, Open banking in Australia, Australian Business Lawyers & Advisors, December 2017. See also: https://www.ablawyers.com.au/news/open-banking-in-australia

[ii] A series of recommendations to enable the introduction of "an open banking regime in Australia under which customers will have greater access to and control over their banking data" were set out in the Australian government's recent report into open banking (the Farrell Report) which was released on 9 February. While banking was the focus of the Farrell Report it presciently noted that "banking would be an early implementation of broader reforms granting consumers easier access to data in multiple sectors", with the implementation of a Consumer Data Right to "be prioritised in the banking, energy and telecommunications sectors, before being rolled to other industry sectors over time". The Australian Government the Treasury, Open Banking customers' choice convenience confidence, Scott Farrell, December 2017, p3. See also: https://static.treasury.gov.au/uploads/sites/1/2018/02/Review-into-Open-Banking-_For-web-1.pdf

[iii] Deloitte, Open Banking, How to flourish in an uncertain future, June 2017. See also: https://www2.deloitte.com/uk/en/pages/financial-services/articles/future-banking-open-banking-psd2-flourish-in-uncertainty.html.

[iv] For example, banks could establish an ecosystem of different providers to provide an interface via which customers can perform all stages of a process such as buying a home. Some banks could even decide to focus entirely on providing such services, and may no longer even choose to be engaged in traditional banking. Deloitte, Open Banking, op. cit. p3

[v] Deloitte, Conduct: Are you in? It's everyone's responsibility, December 2017. See also: https://www2.deloitte.com/au/en/pages/audit/topics/conduct.html

[vi] Wheatley, Martin, 'The Fairness Challenge', transcript of speech, Financial Conduct Authority, 24 October 2013. See also: https://www.fca.org.uk/news/speeches/fairness-challenge

[vii] Medcraft, Greg, Chairman, Australian Securities and Investments Commission, The human factor: Is conduct risk on your radar?, Speech to the Institute of Internal Auditors, 25 July 2017.

Fairness

Martin Wheatley, Chief Executive of the UK Financial Conduct Authority (FCA), has said: "The dominant theme of 21st century financial services is fast turning out to be a complicated question of fairness".[viii] The Terms of Reference for the Farrell Review specifically note that 'Open Banking needs to be capable of balancing the needs of different participants to ensure that the system is fair to everyone.'[ix]

With the inception of the first phase of Comprehensive Credit Reporting from 1 July 2018, an early step towards open banking in Australia, the ability to discriminate on price by both incumbent financial institutions and new entrants will be greater.[x] The implementation of strategic pricing, including risk based pricing, raises potential fairness questions particularly if certain customer segments experience significant increases in their price of borrowing, or are unable to access credit altogether.

Analytics and algorithms: Analytics and algorithmic pricing could inadvertently change the pricing or access to credit for very specific customer segments. This could discriminate against a protected class of people[xi]. If organisations adopt strategic pricing in response to open banking and CCR they will need to adjust for socially sensitive data such as gender, ethnic background, and family status.

Historical data: Bias can also be introduced where loan approvals are based solely on repayment history. Axiomatically, it is not possible for an algorithm to determine the potential repayment history for loans which were not approved. This could introduce bias into a credit assessment or credit pricing algorithm for certain groups of people.[xii]

Credit assessments and pricing: If considerations of fairness prevent a bank from adjusting its pricing when the risk of a customer deteriorates after origination, this will need to be reflected in the risk based pricing algorithm. This means that credit assessment and pricing models will need to be robustly validated given the greater risk of losses from incorrect model development or implementation. Model governance must extend to the strategic and tactical implications of model decisions which might influence pricing for different strategic customer groups.

To account for these factors financial institutions will have to:

- Determine which type of biases to remove
- Assess direct and indirect fairness considerations
- Determine when fairness considerations will apply to groups and when to individuals
- Understand the difference between disparate treatment (intentional discrimination) and disparate impact (unintentional discrimination)
- Include both unfairness prevention and unfairness discovery in their model validation.[xiii]

These obligations will apply to both incumbents and new entrants. They may be more onerous to implement for non-traditional players with a limited track record in algorithmic pricing.

Vulnerability

Vulnerable customers are those who, due to their personal circumstances, 'are especially susceptible to detriment, particularly when a FI is not acting with appropriate levels of care'.[xiv] This cohort of customers is typically a higher credit risk, with fewer finance options available to them. So although considerations of fairness apply to all customers, they are particularly relevant to vulnerable customer groups.

Where financial institutions use the additional information from open banking and CCR to price discriminate between customers with differing credit risks, some vulnerable customers may be in a better position to demonstrate credit worthiness. However other vulnerable customers may be disadvantaged if they experience a significantly higher price for credit, or are excluded from access to finance altogether. In the UK, the FCA is particularly concerned that vulnerable customers, such as the elderly, may be losing out as banks find 'new ways to price discriminate'.[xv]

Any strategy to avoid intentional or unintentional discrimination will need to consider actions at origination and throughout the customer relationship. Importantly financial institutions – both incumbent banks and new entrants – should understand how their own actions might compound poor customer outcomes. They should consider providing discretion to customer relationship managers as they apply terms and conditions in lending agreements.

Existing responsible lending obligations in Australia provide an appropriate standard for developing a strategic pricing response to open banking. Credit providers need to ensure their strategic pricing programs will not provide credit, or alter the terms of an existing credit facility, such that repayments impose substantial hardship on the customer.

In the UK the FCA recommends vulnerable customers be referred to specialist teams with the authority to make decisions on providing more flexible financial terms.

Other questions that need to be addressed include:

- If everyone is competing for the better risk customers, what social banking obligations should organisations have to avoid financial exclusion?
- How do you make sure that these apply equally to new entrants as well as to incumbents?

The industry – both incumbent banks and new entrants – will need to ensure that vulnerable customers can fulfil their banking needs without being pushed towards predatory lenders.

Notes

[viii] Wheatley, op. cit.

[ix] The Australian Government the Treasury, op. cit, p9

[x] Comprehensive credit reporting must be fair for all, Australian Bankers Association - Media Release, 7 March 2018

[xi] Petrasic, Kevin with Benjamin Saul, James Greig, Matthew Bornfreund, Algorithms and bias: what lenders need to know, White & Case, 20 January 2017. See also: https://www.whitecase.com/publications/insight/algorithms-and-bias-what-lenders-need-know

[xii] This is known as sample selection bias

[xiii] Kamishima op. cit.

[xiv] Financial Conduct Authority, Consumer Vulnerability, Feb 2015. See also https://www.fca.org.uk/publication/occasional-papers/occasional-paper-8-exec-summary.pdf

[xv] Starks, M, Competition Policy in Financial Markets – the view from the regulators, transcript, Financial Conduct Authority, 22 June 2016. See also: https://www.fca.org.uk/news/speeches/competition-policy-financial-markets-%E2%80%93-view-regulators

Transparency

Transparency means that better informed customers can be more conscious of their credit rating and behavioural factors that can affect perceptions of their credit risk.

The Farrell Report says that 'standard economic theory, and a range of corroborating empirical evidence, suggests that markets work most efficiently when: customers are informed; there is transparency in pricing and in the quality of available products and services; there is a level playing field between competitors; and where the costs of switching between providers and barriers to entry for new providers are low.'[xvi]

In addition to transparency of pricing and product features, financial institutions should be transparent with a customer about how their credit and pricing decisions are made.

The US Federal Trade Commission (FTC) is leading the way through its Risk-Based Pricing Rule which requires lenders to notify consumers if they are getting worse terms of credit than those available to other consumers because of information in their credit report. In the US transparency regarding risk based pricing requires customers to be able to:

1. Access information about how their risk-based price is determined
2. Understand in plain language the information used by the financial institution in determining the price of credit for that customer
3. Compare how risk-based pricing is implemented across different organisations to improve market competitiveness and prevent barriers to customer mobility and choice.

US financial institutions also have to suggest ways in which customers can improve their perceived risk, such as paying down debt, or obtaining co-signing guarantors. This should be seen as a core principle for the fair and transparent implementation of strategic pricing in Australia.

Under UK open banking regulations, banks are also required to publish accurate and unbiased information that lets consumers evaluate their service quality. Transparency on service quality is intended to encourage banks to deliver a better customer experience.[xvii]

As Australia's open banking regime matures, it is possible that similar obligations will apply here either as a result of legislation or community expectations. Financial institutions could face a duty to disclose the factors used in determining the customer's credit risk and what it means in terms of their available pricing. They could also need to educate customers on the impacts of these factors. This would need to be communicated clearly so that it was not perceived as 'advice'. APIs may enhance conduct outcomes, provided the privacy safeguards do not create new forms of opaqueness and inhibit transparency.

Financial institutions must ensure that, regardless of the method used to determine customer riskiness, that method is applied consistently for all customers across all distribution channels – broker networks, digital channels and direct customer contact centres.

Notes

[xvi] The Australian Government the Treasury, op. cit, p6
[xvii] Deloitte, Open Banking op. cit.

Suitability

Suitability is a question of whether an organisation should reasonably know there is a better option for the customer based on the information it has. This is a relative rather than an absolute test.

One of the advantages claimed for open banking is that new entrants will be able to provide new products and services to customers.[xviii]

Suitabilty considerations will be particularly important when these new products and services have been developed for specific customer groups, such as the significant minority of Australians classified as financially excluded or with unstable incomes. For example CCR, effectively a component of open banking, is likely to result in additional information being available for this group of people.[xix] By pooling available information on financially excluded customers, financial institutions may be able to get a more complete picture of a customer's financial situation, and develop products and services that are better tailored to their needs.[xx]

However there are claims that new entrants and new untested products can, and have in the past, led to significant predatory behaviour. Concern has also been expressed that additional choice can lead to additional complexity 'particularly for vulnerable and disadvantaged consumers.'[xxi]

The changes in products and services offered by financial institutions and new entrants as a result of open banking are likely to result in additional compliance obligations to determine, and document, the suitability of a product for a customer based on their specific circumstances.

Key questions organisations should ask

As organisations prepare for open banking they will need to be able to answer the following questions:

1. Do we use the additional information from open banking to make 'fair' decisions about access to finance and pricing?
2. How will the additional information available from CCR be used to re-assess who the vulnerable customers of an organisation are?
3. How will we treat vulnerable customers given the additional information?
4. Do we communicate clearly and transparently with customers the reasons why we have made our decisions on pricing and access to credit?
5. Do we have processes in place to ensure that customers have been notified when getting worse terms because of information in their credit report?
6. Are we confident that the customer data in our systems is complete?
7. Does strategic pricing lead to more suitable customer outcomes?
8. Do we have appropriate processes in place to ensure that there is no potential selection bias in algorithms we use?
9. Do our processes adequately document the decision making process and the customer communications?

Notes

[xviii] The Australian Government the Treasury, op. cit. As part of its open banking initiative, the Australian government has stated it intends to facilitate the implementation of a wide range of new financial products and services, by allowing businesses to evaluate the commercial viability of new concepts without a licence but subject to meeting minimum consumer protection obligations

[xix] The Australian Government the Treasury, op. cit

[xx] Canstar, Australia now has Positive Credit Reporting – and you will benefit, Canstar, 2017. See also: http://www.canstar.com.au/credit-score/what-is-positive-credit-reporting/

[xxi] Consumer Action Law Centre et. al., op. cit.

The last word

What matters is trust. It is critical that the industry implements open banking well – for the benefit of the customers it serves, and their confidence in the industry.[xxii] As open banking is adopted it will also be important that organisations ensure that their response fits with their strategy and is reflected in decision making and operating models. For example:

- How will we define fairness in the bank's context?
- To what extent should the bank have offers that suit every customer cohort, including those that are unprofitable or only marginally profitable?
- What are the implications in terms of the organisation's overarching strategy?
- How do we stay true to broad and positive mission statements, and also become more targeted in our customer focus?
- How should the bank work with customers when there is push-back against one of these decisions?

The recent introduction of legislation to streamline the complaints process by establishing the Australian Financial Complaints Authority (AFCA) will create a 'one stop shop' for resolving issues in the financial services industry. It should be an important step in improving trust and ensuring that conduct considerations are integrated into an organisation's response to open banking.

Notes

[xxii] Financial Conduct Authority, Regulatory priorities for retail banking, Speech by Karina Mc-Teague, Director of Retail Banking Supervision at the FCA, delivered at Westminster Business Forum on Retail banking and payments, published on 23 November 2017

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