Turning the Revised Payment Services Directive into Digital Opportunity

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1. Introduction

The European Commission's most recent steps toward creating an open payments market across the European Union are rippling through the banking industry. The Directive on Payment Services (PSD1), which went into effect in 2009, provided the legal foundation for the creation of an EU-wide single market for payments. In October 2015, the Directive on Payment Services was revised by the European parliament. The revised Directive on Payment Services (PSD2) is the latest in a series of legislation by the EU to enable modern, efficient, and inexpensive payment services and to enhance protection for European consumers and businesses. Building on the foundation laid in PSD1, the new rules are intended to better protect consumers when they make payments, and promote the development and use of innovative online and mobile payment capabilities.

PSD2 came into force on January 13, 2018 and by Q3 2019, banks will have to most likely comply with the regulatory technical standards by European Banking Authority (EBA RTS). For those banks already progressing in their digital transformation, this is a reasonable timeframe to incorporate the necessary technology and business change. For those that have yet to embrace digital, key components of a digital infrastructure are needed and time is short.

The Main Impacts of PSD2

PSD2 has numerous new requirements, some impacting banks more than others, depending on the specific institution's service portfolio and strategy. Three with the most significant impact include:

- **Strong authentication and secure communication:** Strong Customer Authentication (SCA) is required in three situations: online access to the payment account, initiation of electronic payment transactions, or actions carried out via a remote channel that may imply a risk of fraud or other abuse. Exemptions might be considered based on the amount and/or recurrence of the transaction, the level of risk involved in the service provided and the channel used for executing the transaction. SCA is a two-factor authentication that requires independency and dynamic linking.
- **Third party provider regulation:** PSD2 extends the definition of Payment Institution by introducing new types of Payment Services Providers (PSPs). Credit institutions and electronic money institutions are considered Account Servicing Payment Service Providers (ASPSPs) that provide and maintain payment accounts. Third-party providers (TPP) that are also considered payment-services providers under the regulation include Payment Initiation Service Providers (PISPs) and Account Information Service Providers (AISPs) that act as aggregators of customer payment accounts information. PSD2 brings AISPs and PISPs in the scope of regulated entities.
- **Access to payment account (XS2A):** Under PSD2 all registered PISPs and AISPs and all licensed PSPs are to have access to payment accounts held at ASPSPs under explicit consent of the client. ASPSP must share all data enabling the AISP or PISP to perform the service requested by the client. PISP/AISP may not use, access or store any data for other purposes than provision of the requested service.

2. The Business Risk PSD2 Presents

"Business APIs–the digital embodiment of key business capabilities–are central to strong API strategy. They prepare an organization to respond to any disruption. More importantly, they allow an organization to cause disruption of its own through innovative business models and new products and services for new ecosystems. European banks can take a strategic approach to PSD2."

Source: Forrester Research: "APIs Turn Disruptions Into Business Opportunities", Randy Heffner, January 5, 2016.

A main difference between PSD2 and PSD lies in the new requirements to provide third parties with 'access to the account' (see sidebar "The Main Impacts of PSD2). With PSD2 implementation, third parties can obtain access to customer accounts for account information and payment initiation services provided the consumer provides consent. This poses a security concern for banks to ensure that account access is controlled and authorized. It also poses a liability concern that, if something goes wrong in the customer's service from the third party, the consumer may hold the bank liable. While these are important considerations perhaps the biggest business risk for banks is disintermediation.

Allowing third parties to access a customer account enables them to come between the bank and its customer, and strain the bank's customer relationship. It also lowers the barriers to entry for third parties with new ideas for value-added services. Today, third parties with innovative ideas are often unable to execute because they don't have captive customers and banks are not willing to or even allowed to provide access to account information. PSD2 makes it easier for third parties to provide value-added services and grow viable businesses as banks will be required to provide access to customer data with permission.

Figure 1: How payments model will change (cards-based example)

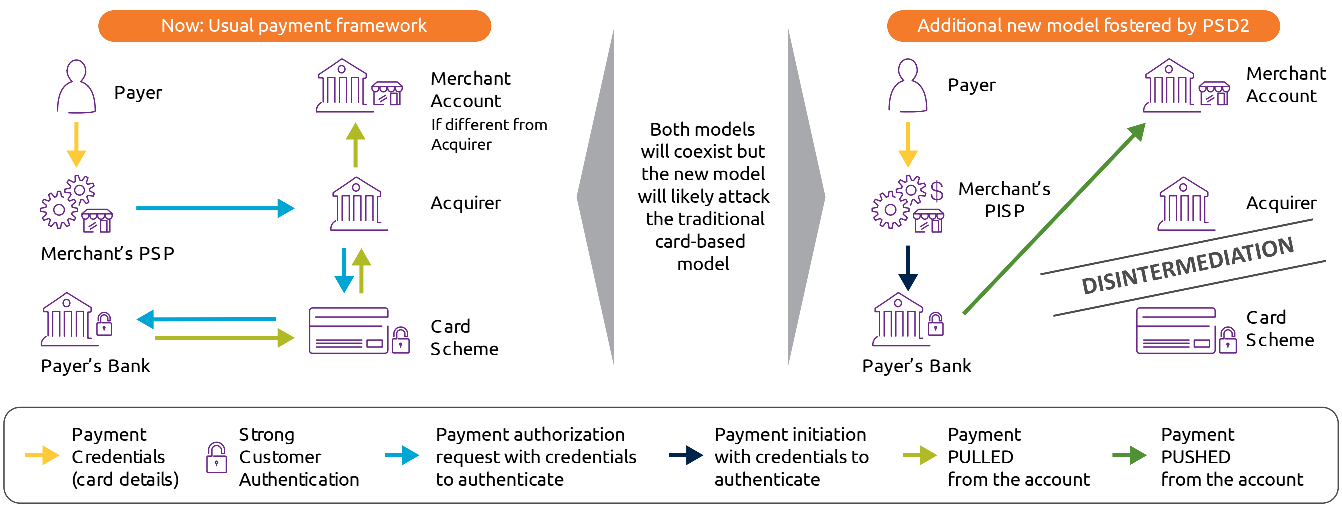
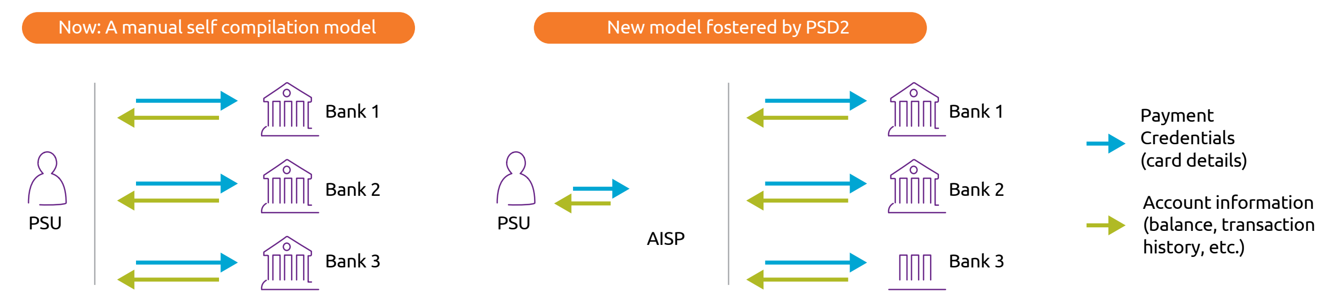


Figure 2: New possibilities for account access

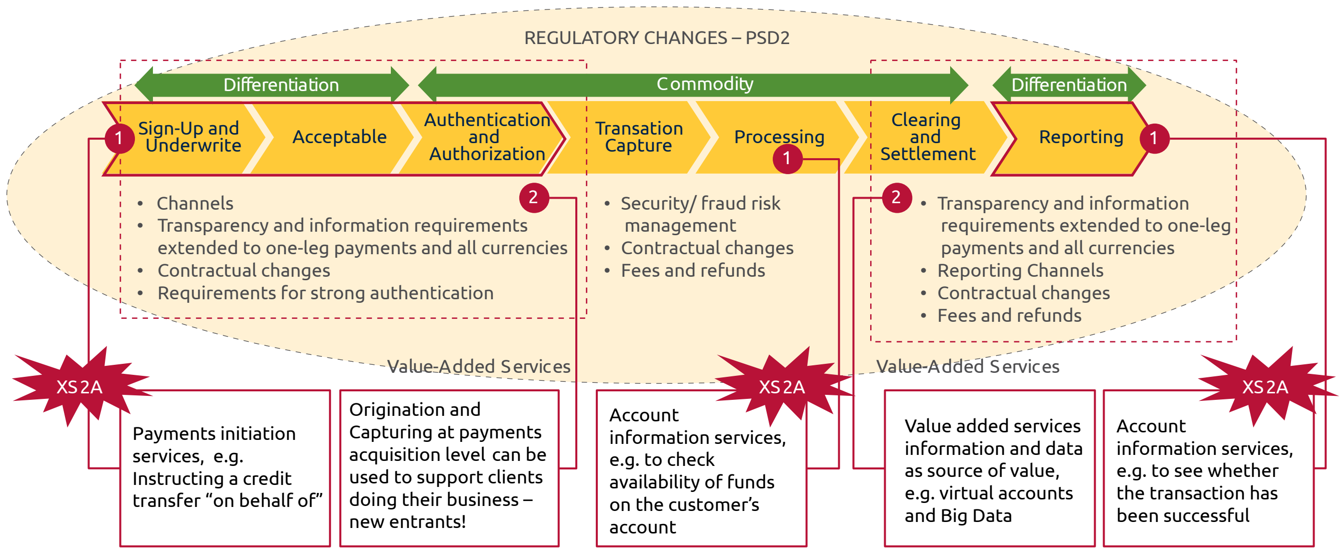


1 The Telegraph, March 26, 2017 "This year 525 banks will shut: will yours disappear?"

For example, expectations are that it will be possible for an account information service provider (AISP) to give a customer a consolidated view of his entire financial relationship across multiple banks. The AISP can then provide value-added offers such as alerting the customer that a credit card he is holding is not as well-suited as another available, and it can document the savings potential from switching based on the customer's own personal spending habits. Through such services AISPs become the value-added face to the customer and the banks risk losing the customer's loyalty and "stickiness".

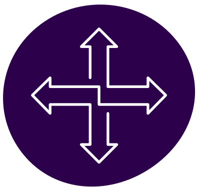
PSD2 has an impact on every part of the payment value chain, with a particularly high impact on areas with high innovation potential such as Acquiring & Reporting (Refer to Figure 3).

Figure 3: Impact of PSD2 across the payments value chain



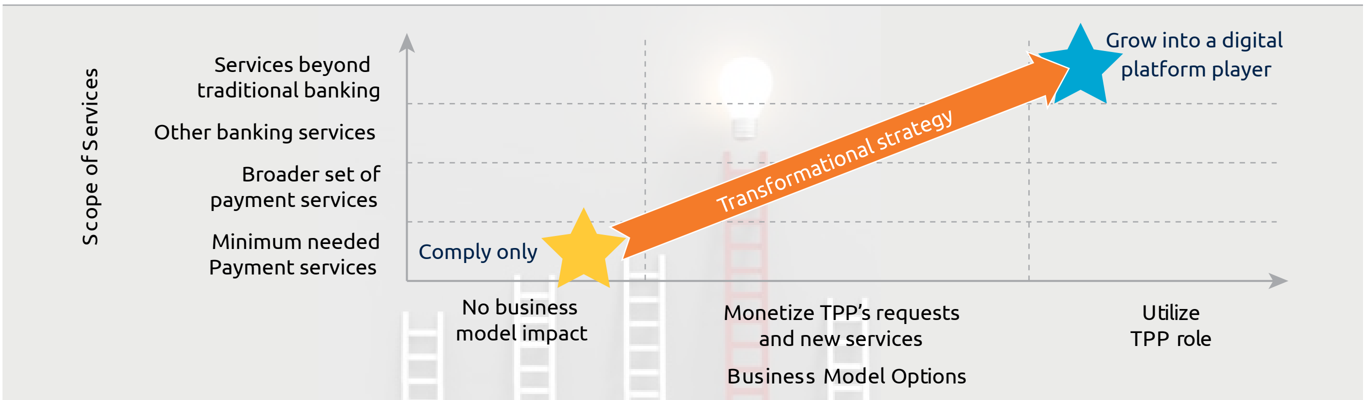
The disintermediation risk for banks is real. It is well underway in other industries such as energy and utilities and telecom. The energy industry value chain has constantly evolved under pressure from technological progress and regulation, especially the global deregulation drive of the past 20 years or so. In the process, the energy value chain has separated, creating distinct business propositions in each segment. Companies can still operate in all segments, but vertically integrated monopolies have become less common. Network and service provisioning are separated, and specialist players have emerged to cater to specific needs within the value chain (generation, wholesale, distribution, retail, aggregation). A similar value-chain split has occurred in telecom with network infrastructure separating from content delivery and the emergence of new entrants offering over-the-top services and Internet content services.

3. The Opportunity for Value Creation



To succeed in post-PSD2 era and remain relevant into the future, banks should look at PSD2 compliance as not only a requirement, but as an opportunity for value creation. Banks' strategic options are plentiful if they think more broadly than just complying with PSD2. Through different collaboration models, banks can offer advanced payment and account information services, expand to services in other areas of banking and explicitly expand their service portfolio beyond traditional banking – all of which can lead to differentiation and new sources of revenue.

Figure 4: Value Creation Opportunities



"PSD2 holds the potential to reshape financial and payment value chains and reduce the influence of incumbent financial institutions that strive to only comply with the regulation. We believe CIOs in the EU that move quickly and aggressively can turn PSD2 into an opportunity to accelerate open banking and digital transformation. The way to do this is to use platforms to enable new business models, operating models and ecosystems."

Gartner Inc.: "Use PSD2 to Accelerate Open Banking", Kristin R. Moyer, Christophe Uzureau, Alistair Newton, 19 February, 2016

Consider one bank that has the foundation of the digital infrastructure for collaborative business models already in place. The bank created an application programming interface (API) with an online travel service that books a high volume of international travel. Through this API the travel service can offer its customers the opportunity to purchase foreign currency from the bank at the time they are booking international travel. It is a new business model for the bank that opens up a new revenue stream at very low sales and distribution cost. By opening one "door" (the API) to a collaboration partner, the bank is accessing that partner's entire customer population as potential customers.

APIs are the recommended technical means by which banks provide account access to third parties as part of PSD2 compliance. Strategically, they are the mechanism to support new forms of collaboration with a whole ecosystem of business partners. In this context, the approach to building APIs is critical. The collaboration between the bank and travel service was the result of the bank thinking holistically about its strategy. The bank was originally approached by a commercial customer wanting it to provide them with an API for downstream payment processing. Rather than creating a single solution for this important customer, the bank thought more broadly about its API platform.

The IT organization worked through a process with the business to define the types of APIs to host and the potential business models they would support. Through this approach the bank solved the problem for its initial customer and laid the foundation to be able to offer the travel service an innovative new currency-exchange service. Encouraged by its initial success, the bank is now looking at launching approximately 1000 open APIs over the next few years.

Similarly, a French bank built one app in a year with a closed API approach. It then moved to an open API approach, monetizing the platform to let third party build new apps (80+ new apps in two years) signaling the power of open innovation.

4. Making it Happen

An open API platform strategy builds on the banks' core strengths of trust and brand recognition and customer information assets. It also allows the bank to build on the strengths of non-bank innovators that are often more agile and fast-paced in innovation.

Banks have the opportunity to turn a PSD2 regulatory-compliance investment into business differentiation. To follow this path, consider the following three recommendations.

Capitalizing on regulatory momentum to get digital transformation moving. For European banks, PSD2 compliance is a requirement. APIs are the path to provide account access and payment initiation. The regulation serves as the momentum for banks to move out of digital inertia, align stakeholders and embrace digital transformation through a structured approach.

Taking three immediate actions. There are many business and technical components to driving benefits from PSD2. Consider immediate actions in these three areas:

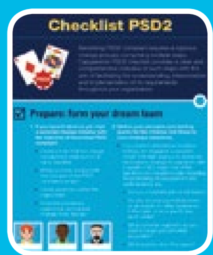
- Build the business alignment and strategy to anticipate opportunities and threats and to define new positioning.
- Assess current Open API program capability and determine how to execute in the timeframes required.
- Construct an ecosystem of partners, FinTechs and developers that can help the bank evolve new business models around the Open API program.

Determining ways to accelerate the process. Across the actions required, there are mechanisms available in the market to accelerate the implementation program. For example, consider: following a service provider's proven approach to bring stakeholder alignment and define new positioning; leveraging pre-defined solutions to implement an open API platform; and collaborating with existing Innovation Hubs to access a rich eco-system of partners and FinTechs.

PSD2 Six-Step Checklist

1. Prepare by forming your dream team
2. Interpret the PSD2 text
3. Analyze the requirements to build a plan
4. Define your solution which will include multiple parallel activities
5. Implement, test and communicate
6. Align to the market

Click here for a more detailed checklist



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