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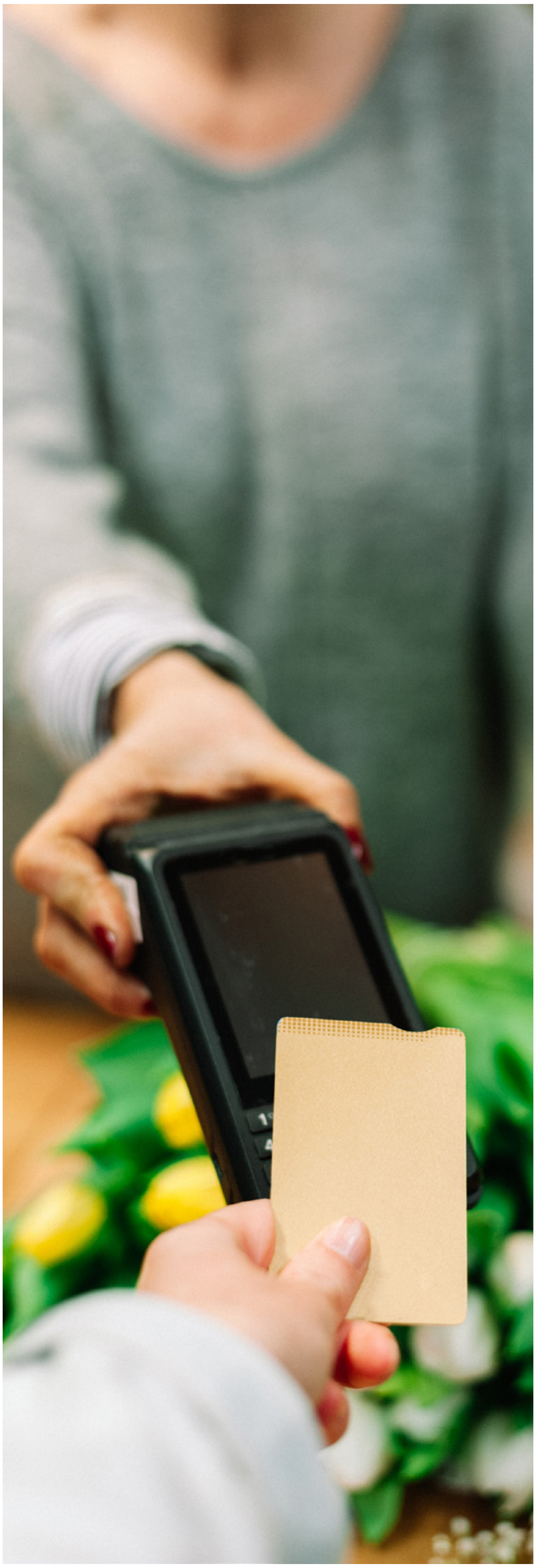
# PSD2 review

**Status of the EU payments market**



# Introduction

In 2007, **the first Payments Directive** was implemented to regulate all payment services and payment service providers in the EU. This **regulatory framework** allowed for the first time, financial institutions without a credit institution license to provide payment services. Several elements prompted a review of the Directive: continuous evolution of the payment market, new players joining the market and the development of new payment services not under the scope of any regulation.

In 2018 **the revised Payment Services Directive (PSD2)** was launched to address these **new market conditions**. It extended the PSD regulation to international payments and to new payment actors.

**The payments market has continuously evolved**, as new technologies were developed and customer demands grew. New digital payment solutions are created daily and the use of third party services when performing payment transactions is becoming more common.

The **COVID-19 pandemic** had a big impact on these trends. The lockdown forced many people to change their habits related to payments, and led to an increase in non-cash transactions (cards, digital wallets) to avoid physical contact and a significant rise in e-commerce.

Given all these developments, it might be necessary to assess whether PSD2 has fulfilled its objectives and if it still remains fit for its purpose. In this context, **the European Commission has launched a public consultation** to assess the impact and current relevance of PSD2 and determine its continued suitability for its purpose.

# PSD2 explained

The Directive aimed to increase security in payments and customer protection while fostering competition and innovation. One of the main objectives of the regulation was to align the payments market with the current technologies available in the market.

PSD2 established new ground rules in the payments ecosystem, laying the foundation for Open Banking. It disrupted the traditional payments value chain and eased the inclusion of third party providers.

### PSD2 enforced customer protection through greater transparency towards clients

PSD2 increased customer rights in several areas and reduced the client responsibility in case of unauthorized payments. PSUs now enjoy higher transparency, information about payment services and their terms and conditions must be always shared with them.

### PSD2 has enabled the development of a safer payments market

The Directive mandates the implementation of requirements to prevent fraud, such as transaction and device monitoring mechanisms or reporting of payment transactions to the competent authority.

Nevertheless, **one of the key components regarding security was the development of Strong Customer Authentication (SCA)** to prevent fraud early, and make payments more trustworthy. SCA requires the use of two authentication factors (knowledge, possession or inherence) for the initiation and processing of electronic payments.

### The directive, fostered innovation and competition in the payments market, which has led to a wider choice for consumers

PSD2 made it mandatory for banks to provide access to customers' banking accounts through APIs if the client requested it. This factor, eased the entrance of new players in the market and the subsequent development of new business models such as Payment Initiation Systems (PIS) and Account Information Services (AIS). These new players, developed new services and ways of payments created on top of the existing banking data.

| Payment Initiation Systems (PIS) | Account Information Services (AIS) |
|---|---|
| PIS are third parties that initiate payments on behalf of the payer | An AIS provides consolidated information on payments accounts |
| Linxo | Linxo allows users to compile information of their different bank accounts and financial investments in the same place and provides insights to control the budget. Besides, it allows users to transfer money between their accounts without going through the bank's applications. |

Under the principle "same business, same rules", in exchange for the access to information, TPPs had to comply with the same rules as the legacy payments service providers: authorization and regulation.

The access to payment accounts requirement increased competition for banks and pushed them to innovate, which ultimately led to a wider choice for consumers. Nevertheless, BigTechs could significantly disrupt the market since they can combine the payments data with their non-financial data, which creates a competitive imbalance with banks.

### PSD2 required substantial investments and the benefits are still unclear for some participants

Payment providers had to amend their systems to comply with the regulation and adapt to the new environment, especially with regards to SCA and access to the information held on payment accounts by third parties. This was translated into significant costs for market participants and no direct financial benefit.

This is particularly relevant in the case of private banks, who provide payments as ancillary service, since PSD2 was mostly tailored to retail clients. Private banks are unsure whether their clients will use the new services and give consent to their wealth management accounts and have difficulties to come up with a value proposition.

In some occasions, the obligation to provide free access, discouraged some players to develop high quality APIs since they did not see a clear economic incentive. Nevertheless, most of these players do not account for the missed business opportunities this could cause.

In addition, the implementation of SCA created some business disruptions not foreseen in the regulation: it added frictions to the online payment journey and it required the use of a smartphone, which excluded part of the population and provoked, in some occasions, the inability to provide payment services.

**PSD2 added some hurdles due to the multiplicity of texts and the complexity of the regulation**

PSD2 consists of several documents (Directive, Regulatory Technical Standards, Guidelines, Q&A…) issued by different bodies and intended for different publics.

The existence of multiple texts, with overlapping concepts and unsynchronized updates, increased the complexity of the implementation and required continuous investment to comply with the regulation.

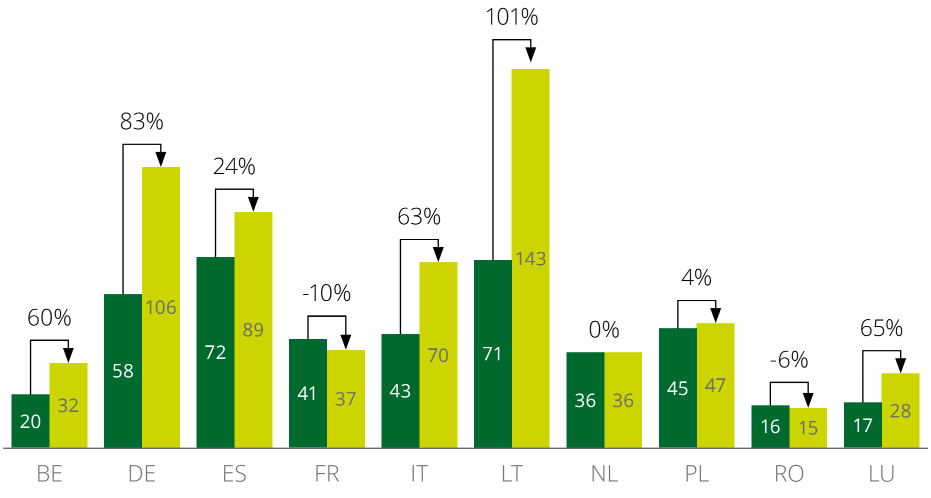
It is especially relevant the case of the E-Money Directive (EMD2), since the distinction between e-money institutions and payment institution is blurry, especially for customers, with both institutions offering similar services.

**Implementation of the Directive among Member States (MS) varies due to diverse interpretations of the regulation and difficulties cross-border operations**

PSD2 allows to passport the licenses and provide services in another EU states to create a pan-European payments market. However, the different interpretation on some PSD2 concepts (i.e., access to payment accounts, agent/outsourcing) and the additional requirements established by local authorities for players operating across markets, decreased the effectiveness.

Worth mentioning are the differences in the licensing procedure. The distribution of 3-party licenses is unequal around Europe. Most of the new licenses are located in Lithuania which could imply that they have a simpler and quicker approval process than other EU countries.

**Number of PSD2-licensed third-party providers 2017 and 2021**[1]




| | Q4 2017 | Q4 2021 | Increase (%) |
|---|---|---|---|
| **Euro area** | 603 | 801 | 33% |
| **EU 27** | 1065 | 1162 | 9% |

1. Source: https://www.ecb.europa.eu/stats/pdf/money/psri/psrispercountrytypeofeconomicactivity.pdf?a6648f4f74759341b0922e752f028905

### The lack or harmonization between markets impedes the potential for value creation in Open Banking

Although PSD2 alleviated the entrance of new players linked to payments, there is still room for improvement regarding harmonization. PSD2 does not establish common API standards, banks have created different APIs to access their data. Hence, TPPs need to decide to whom they should connect and this decreases the choice for consumers.

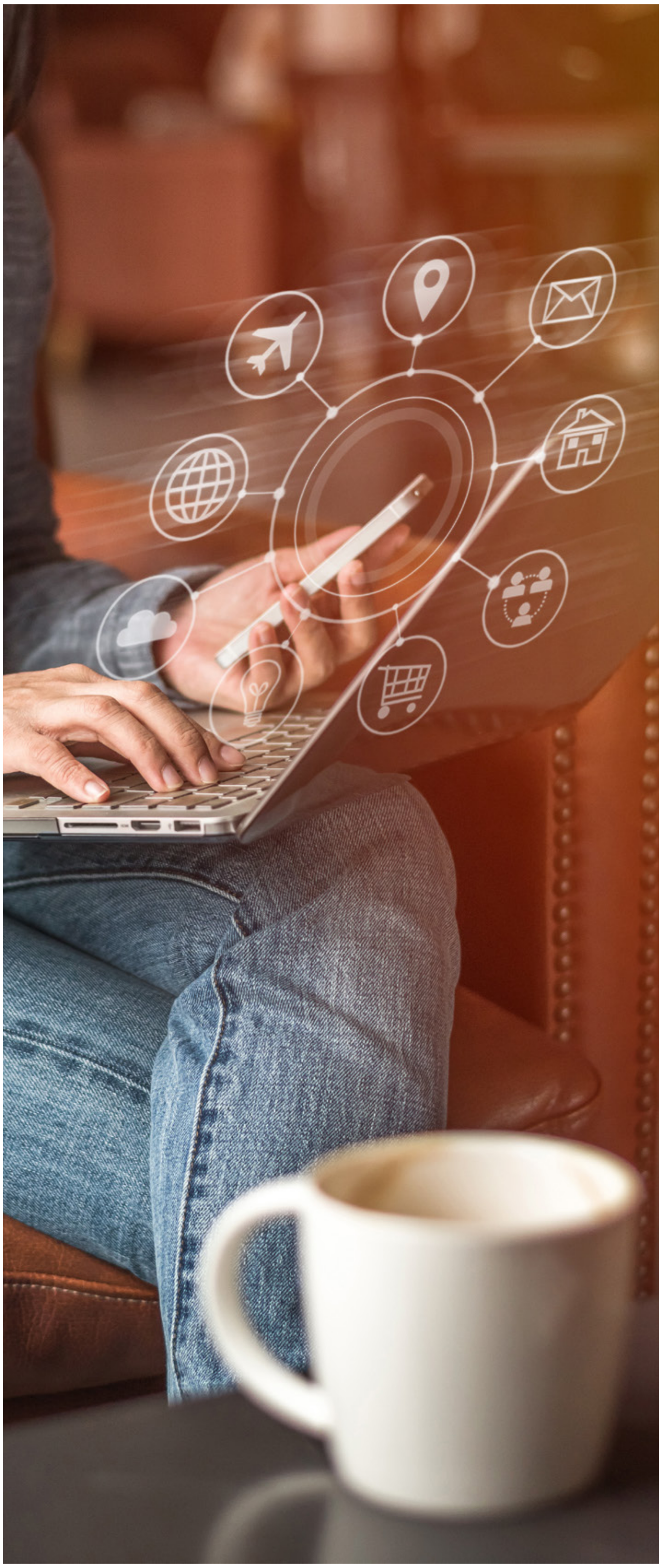
This lack of an API standard alignment across markets added to the inconsistent application of the passporting regime, difficulties cross-border activities and clients cannot find a provider that covers their various payment accounts from different countries. Consequently, **Open Banking is mostly absent in Europe as only its payments stream has been developed, with only a few banks pursuing independent initiatives**. Its use and "flows" are restricted since "wealthy clients with cross-border interest" (the ones that could create the traffic), appear to lack interest ed as they cannot see more than payment accounts and the scarcity of cross-border players. Due to the latter, wealthy clients cannot find a provider that covers their various payment accounts from different countries.

However, for players that only act within one domestic market as well for retail client, the current scope fulfills its purpose.

### PSD2 has succeeded in creating a safer and more secure payments environment while also improving the overall payment experience. However, consistent application and harmonization are still needed

Determining the success of PSD2 is challenging because some of the benefits are yet to be fully materialized. Some objectives have been met, especially with regards to security, innovation and greater transparency towards clients. On the drawbacks, there is a need for further harmonization in some practices and consistent application among MS.

Overall, it might be said that most of the issues the regulation wanted to tackle still remain relevant today and as different trends are shaping  the market, the path ahead becomes clearer.



# What is expected in the future

**Although PSD2 strengthen security requirements regarding electronic payments, newer and more sophisticated types of fraud continue to emerge**

As the market evolves, more sophisticated types of fraud are surfacing (combinations of phishing and social engineering). This trend is expected to become increasingly widespread in the future. The digitalization of day-to-day activities, the rise in e-commerce and digital payments, makes society more susceptible to these threats. Certain segments of the population (i.e., old people) require higher protection due to its lower knowledge of the environment.

An increasing number of companies will likely implement mitigation solutions, such as digital identity or behavioral data analytics to reduce the exposure to payment fraud and identity theft.

The evolution of SCA becomes crucial here, since security should be improved without adding additional friction to the payments.

**Changing customer demand will continue to be the main cause for the development of innovative solutions**

Nowadays customers expect personalized omnichannel experiences that cater to their specific needs.

As mentioned before, the pandemic accelerated the shift toward non-cash transactions, and the shift is predicted to persist. Digital and mobile wallets are expected to gain even more traction, offering more convenient and adapted experiences. For example, in solutions based on biometrics, users can authorize the payment through face recognition or a finger scan.

As a consequence, higher disintermediation in the payments value chain is expected: the usage of PIS and AIP will likely increase, which would lessen the participation of the bank in the payment transaction.

On the other side, the strong increase in e-commerce is leading the shift to instant payments. Instant payments are initiated and settled in a matter of seconds. The ECB responded to this trend and launched a set of measures to increase the availability of instant payments in euro.

But, the bigger disruption will likely be caused by the crypto-currencies. In the future, cryptocurrencies could be used a as common mean of payment and central banks are already considering to launch their own digital currencies. This is the case for Digital Euro, a digital currency that will likely be launched by the ECB.

**As the market evolves, Open Finance is gaining momentum**

New regulatory initiatives, such as Open Finance, seek to provide access to new types of data. With the emergence of new data sharing initiatives, it will be necessary for players to ensure that the diverse regulations are aligned and build on what has already been implemented.

Open Finance will broad the scope of PSD2, enabling data sharing of consumer data beyond payments. Open Finance could provide third parties access to data related to investments, pensions or insurance.

The European Commission has defined it as one of its strategic priorities and has already launched a public consultation on open finance, aiming to obtain an overview on the views and state of play of Open Finance in the EU.

Some players remain reluctant to share "their data" since they do not see any clear benefits and they have concerns regarding the security of data. As PSD2 did, Open Finance will consider that customers should be the ones determining who can access their information.

**New business models, created to extract the maximum value from data, will emerge**

The combination of financial data and non-financial data could unlock new revenue streams and enhance customer experience. The correct use of data will allow to better fulfill client needs, creating personalized experiences adapted to the client's particular situation and tastes.

Players with systems in place to extract the value of the data provided will be better positioned to cover client needs and sell their products.

Customers are driving the change since they are every day more aware of the benefits of data sharing. Moreover, as new solutions are developed and the business case becomes clearer, more legacy players are becoming aware of the advantages, which expands the move toward data sharing.

# What to do

**From comply to reinvent: use cases for a data sharing economy**

Data could be used to improve decision making processes, with the ultimate goal of improving customer experience. Several initiatives can be built on the foundations of open banking and open finance:

- **Customer onboarding:** data held by other banks can offer a smooth the onboarding process by diminishing the amount of data and forms clients need to provide. Banks could combine this data with digital tools like e-signature and create a seamless onboarding process.
- **Personalized experiences:** existing client data could increase the knowledge of their clients and anticipate to customer needs by offering the right product, for the right customer, at the right time
- **Credit Risk:** information on the client's accounts can improve the calculation of the credit risk. Through data analytics, banks could obtain more accurate lending profiles and provide lending to groups that would have struggled otherwise (self-employed, new/small businesses).
- **Suitability and appropriateness assessment:** financial service providers could leverage on existing customer profiles and customer's current investments data in the suitability and appropriateness assessment. Under this framework, clients will not need to provide information to determine their experience
- **Portfolio aggregators:** players could provide meaningful insights to the client through the consolidation of the clients the investments in one place and provide insights on the current status of the investments

**Collaboration between legacy and incumbents will offer new services, created on top of the traditional banking offering**

In this new framework, banks could decrease their costs and improve time-to-market by building partnerships with companies that already have proper systems in place to extract the maximum value from data. These collaborations will take place through the use of APIs.

Traditional players could exploit their position of "trusted-party" by combining their infrastructure and traditional banking services with third-party value added services, aimed to improve customer experience. These value added services would allow the client to create a personalized journey, tailored to his needs and likes.

# Conclusion

**PSD2 set the foundations of Open Banking and opened the door to effective collaboration between traditional financial service providers and tech companies.**

Some players are not still not fully leveraging in the potential of open banking. However, driven by customer demand and regulation, more participants are being onboarded and the amount of available data is increasing. By broadening the data that can be accessed, new business cases will emerge and players will find the strategy that better suits their model.

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