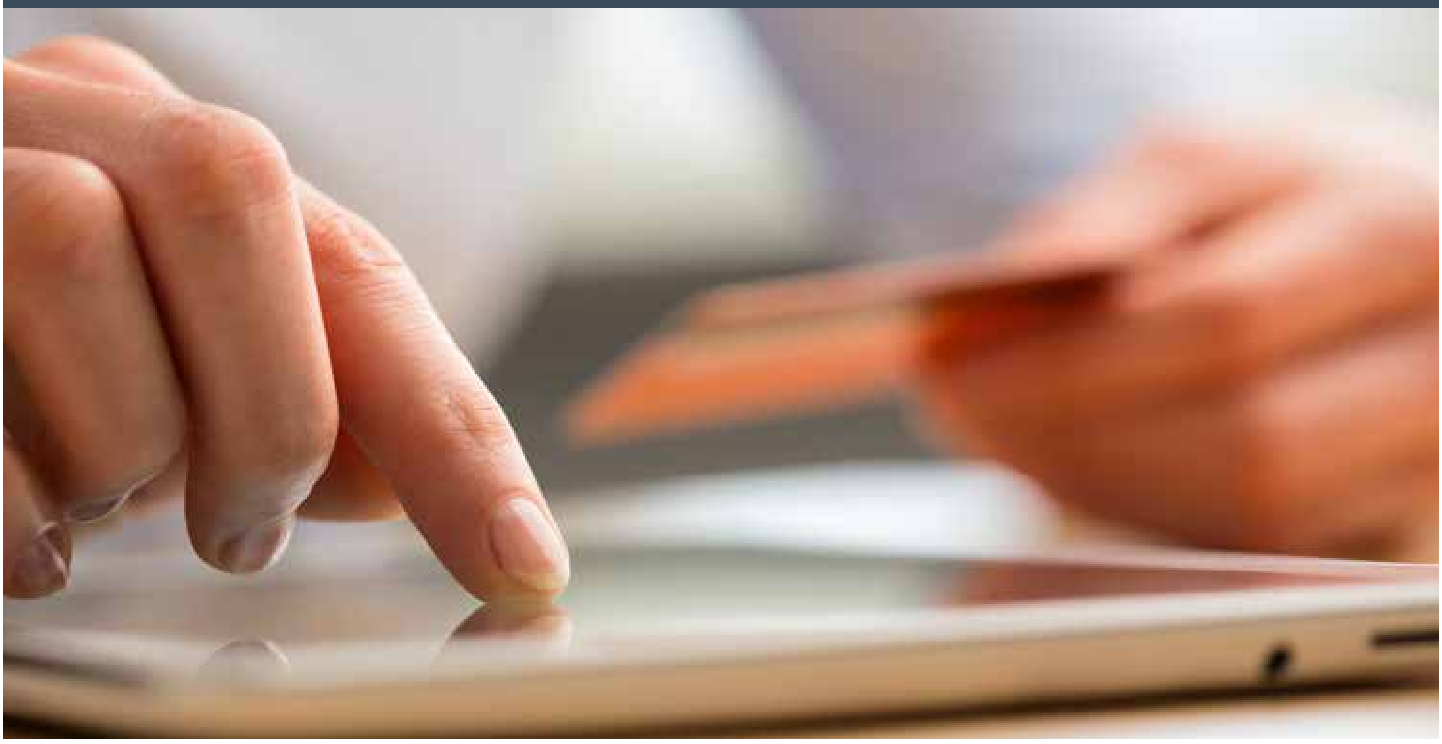
PAYMENT SERVICES DIRECTIVE 2 – WHAT IS ALL THE FUSS ABOUT ANYWAY?

An extract from the Scandinavian financial services newsletter

Winter 2016 Newsletter



Payment Services Directive 2 – what is all the fuss about anyway?

By Frode Lervik and Anders W.A. Olsen

The new Payment Services Directive, known as PSD2, is just around the corner – regulatory speaking.

That is, the directive entered into force on January 12 this year, and the deadline for transposition into national legislation is January 13, 2018. Insiders will know that it has quite a long history within the EU system already and deeming by the loudest reactions, it has managed to frustrate, annoy and worry quite a few for some time already. So what is all the fuss about?

PSD2 is a revision of the first Payment Services Directive. PSD1 was put in place to increase competition in the European payments market and to strengthen consumer rights by implementing the same set of rules across all of the EU and EEA. PSD2 extends the scope of the first directive in several areas.

Among other things, it brings so-called one-leg transactions, transactions to or coming from the Single Euro Payments Area (SEPA) into scope, increasing the scope of the directive significantly. Furthermore, it aims to break down barriers and increase integration in the European payments market by facilitating market access through easier cross-border service-provision. Its companion, the Interchange Fee Regulation (IFR) for card-based payment transactions, is already having impact. It challenges the existing market structures and in particular major card schemes like Visa and MasterCard. This was quite evident in the interaction with the regulators for those present at the recent IFR hearing organised by the European Banking Authority in London.

However, these are not the main points causing controversy. To understand the main grounds for the heated debate on PSD2, you should focus on understanding the concept of a 'payment initiation service' and an 'account information service', together with the rather cryptic abbreviations: PISP, AISP and ASPSP. And for a better understanding, what can be more fulfilling than diving into the PSD2 directive itself? Here is what Article 4 tells us about the services:

> *'payment initiation service' means a service to initiate a payment order at the request of the payment service user with respect to a payment account held at another payment service provider;*

> *'account information service' means an online service to provide consolidated information on one or more payment accounts held by the payment service user with either another payment service provider or with more than one payment service provider;*

Knowing this, it follows quite logically what a PISP and AISP are, even if the directive forces you to have a look in Annex 1 to find the answer:

> *'payment initiation service provider' (PISP) means a payment service provider pursuing business activities as referred to in point (7) of Annex I; Payment initiation services*

> *'account information service provider' (AISP) means a payment service provider pursuing business activities as referred to in point (8) of Annex I; Account information services*

So what, you might say? Services to initiate payments and display account information can hardly be that exciting? Well, let us have a closer look at what hides in the detail of the few, seemingly innocent lines of text we just looked at.

A payment initiation service concerns *"a payment account held at another payment service provider"* and the account information service provides *"consolidated information on..accounts held..with either another payment service provider or with more than one payment service provider"*.

In other words: PSD2 introduces a new set of payment service providers that are allowed to initiate payments and display consolidated information from one or more accounts a user holds with other payment service providers. Who are and may these players be? We are most likely just entering round 1 of the fight for positions in the market for such services but there are already a number of strong, potential contenders.

New Fintech challengers attract a lot attention, offering various forms of online wallets and payment solutions, working fiercely to come up with new solutions and capture positions. Also players like Apple, Google, Samsung and the large card schemes have deep pockets. And finally we see the banks investing in their own mobile payment apps across the whole of the Scandinavian market.

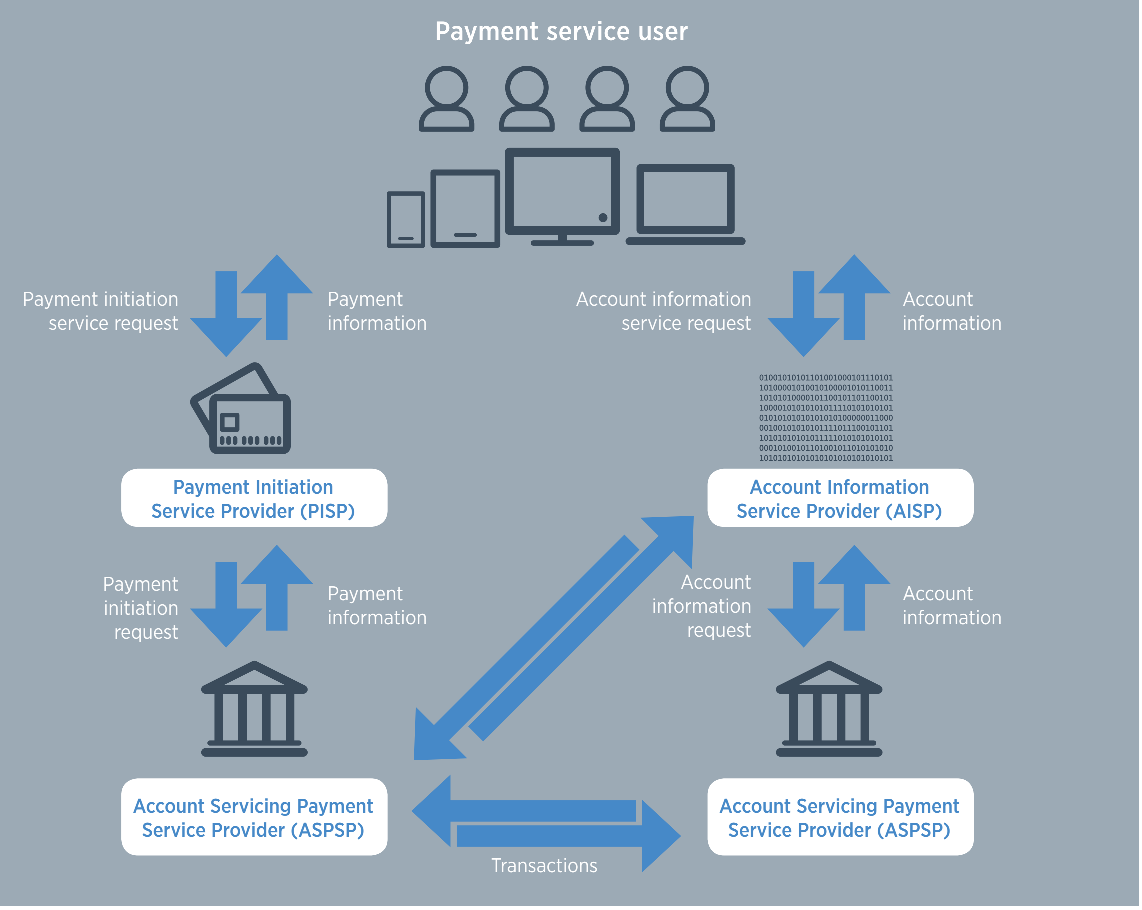
This brings us to the abbreviation that we have yet to explain: ASPSP. Again, we turn to article 4 to satisfy our curiosity:

> *'account servicing payment service provider' (ASPSP) means a payment service provider providing and maintaining a payment account for a payer;*

In other words, the ASPSP provides and maintains accounts. Or in plain English: traditionally the core business of a bank. And the PISPs and AISPs base their payment initiation and account information services on access to these accounts.

So there you go: PSD2 puts a whole new framework in place that has the potential to fundamentally challenge the incumbent banks' position, turning them into 'account servicing payment service providers' as illustrated below:

Figure 2: The new service providers introduced by PSD2



PSD2 does so, not only by defining new categories of payment service providers but also through a number of very specific articles that aim to secure access to accounts for the PISPs and AISPs and prevent ASPSPs from obstructing their access. A few examples are enough to illustrate this:

Article 35 mandates that “rules on access to payment systems of authorised or registered payment service providers should be objective, non-discriminatory and proportionate” while article 36 mandates access to credit institutions’ payment accounts services “sufficiently extensive as to allow payment institutions to provide payment services in an unhindered and efficient manner”.

Article 66 specifies the “rules on access to payment account in the case of payment initiation services” and states that: “Member States shall ensure that a payer has the right to make use of a payment initiation service provider to obtain payment services[..].” and furthermore that “The provision of payment initiation services shall not be dependent on the existence of a contractual relationship between the payment initiation service providers and the account servicing payment service providers for that purpose.”. Article 67 contains close to identical rules for the provision of account information services.

With regards to authentication, article 97 mandates that member states “shall ensure that the account servicing payment service provider allows the payment initiation service provider and the account information service provider to rely on the authentication procedures provided by the account servicing payment service provider to the payment service user”. In other words, in the provision of their services, PISPs and AISPs should be able to rely on the security systems used by the ASPSPs.

Regulatory technical standards will be developed to ensure common and coherent ways to access accounts. This will take some time, and some ASPSPs will need time to be compliant. However, article 115 states that “Member States shall ensure that until individual account servicing payment service providers comply with the regulatory technical standards […], account servicing payment service providers do not abuse their non-compliance to block or obstruct the use of payment initiation and account information services for the accounts that they are servicing.”

So there is a lot of pressure on the ASPSPs to open up for PISPs and AISPs and the directive does not leave much doubt about the intention in this respect. However, this does not mean that the PISPs and AISPs are free to do just anything they would like. Contrary to the impression you get when listening to some industry representatives, PSD2 also sets a number of rules for PISPs and AISPs and brings these service providers explicitly into the realm of union-wide and EEA supervision.

For a start, companies that want to provide payment initiation and account information services need authorisation to do so. To get such authorisation they must fulfil requirements in article 5, which is heavily focused on ensuring safety and reliability for the payment service users. This article mandates security policies, risk assessments and processes to protect sensitive data. PISPs and AISPs also need “to hold a professional indemnity insurance [..] or some other comparable guarantee against liability to ensure that they can cover their liabilities”.

There are also specific rules detailing the information PISPs and AISPs should provide to the payment service users and ASPSPs in connection with the delivery of their services. Article 66 mandates that “the payment initiation service provider shall [..] not hold at any time the payer’s funds in connection with the provision of the payment initiation service; [..] ensure that the personalised security credentials of the payment service user are not [..] accessible to other parties and that they are transmitted by the payment initiation service provider through safe and efficient channels”. The PISPs should also “ensure that any other information about the payment service user [..] is only provided to the payee and only with the payment service user’s explicit consent”. Moreover, the PISP shall “not store sensitive payment data of the payment service user” and “not request from the payment service user any data other than those necessary to provide the payment initiation service”. Neither should they “use, access or store any data for purposes other than for the provision of the payment initiation service as explicitly requested by the payer”. The same type of rules apply to AISPs as specified in article 67, stating among other things, that AISPs should “not use, access or store any data for purposes other than for performing the account information service explicitly requested by the payment service user, in accordance with data protection rules.”.

In other words, PSD2 comes with a whole set of rights for those who offer payment initiation and account information services, but these rights are also accompanied by a number of obligations, some of which have been highlighted above.

To understand the challenge for the incumbent banks, it is not enough to focus on payment services and payment transactions only. You really have to look at the potential power of the combination of payment initiation services with account information services to create new, sophisticated financial aggregation, money management and advisory services.

Essentially, PSD2 drives down the barriers to entry for new competitors to the banking industry and gives new service providers the potential to attack the banks and disintermediate them from one of their primary customer touchpoints. With the customer journey becoming digital and mobile, this is a battle that the incumbent banks cannot afford to lose. At the same time, new players backed by strong investors are ready to give incumbents a serious run for their money.

This creates tension and raises a number of questions, for instance:

- What's hype and what's reality?
- What's the right ecosystem strategy and how do you create sustainable business models?
- Who are the real enemies for the incumbent banks? The other banks or new entrants?
- Are the incumbents able to respond quickly enough to compete with new players?
- When should banks collaborate and when should they compete on their own?
- Will the traditional infrastructure collaboration continue and will incentives remain to invest in infrastructure?
- Is self-regulation sustainable, considering the entry of new competitors?

For those involved in the payments and financial services industry, PSD2 in combination with other industry developments will require a continued, intense effort to create and defend competitive advantage over the coming years. Regulators are likely to be challenged both with regards to their view of the competitive landscape, consumer protection and the processes needed for effective market supervision.

For consumers and businesses this has the potential to stimulate innovation and result in new, innovative and more value-adding financial services but perhaps also to create a multitude of disparate offerings that just increases complexity. There is no doubt that we have exciting times ahead.

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