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January 2017

Successfully navigating changes to payments regulations

Payment Services Directive 2 – A strategic and technological challenge

Roland Berger

THE BIG 3

2018

will be a year of change for European banks with Payment Services Directive 2 coming into effect.

Page 3

1 BILLION

current accounts in Europe are being affected.

Page 5

25-40%

of net banking income is at stake.

Page 14

European banks face a monumental shakeup as a result of a new EU directive that will open up the market like never before.

With new payment rules presenting a direct challenge to the current business models of European banks, there is a lot at stake – not only for firms attempting to capitalize on the opportunities on offer, but for the banks themselves.

The EU Payment Services Directive 2 (PSD2) will open up the market to competition from nonbanks, as well as from smaller, emerging banks. Technological innovations in the way payments are made have been substantial and PSD2 represents a significant step towards "open banking".

With billions of euros in revenue at stake, it is crucial that incumbent banks adapt their strategy in order to prosper post-PSD2. This is all the more pressing, considering many European banks have struggled to generate adequate profits since the financial crisis.

Monumental leaps in the way people use currency have taken place over the last century. We begin with the widespread usage of cash in the first half of the 1900s, before a major breakthrough came in the 1950s with the inception of card payments. In 1958 came the first major credit card, issued by American Express. During the 1980s debit cards gained traction, offering a convenient alternative to cash. In 1996 the pre-paid card was released. At the turn of the millennium, trends in finance went wireless, with electronic options for the transaction of wealth growing in popularity. This included the emergence of smartcards and near field communication technology in 2001-2002, and the revolutionary ability to make payments online and with mobile devices in 2004. In 2018 and beyond, Payment Services Directive 2 will come into effect with an expected significant impact on the way the payment industry is organized.

PSD2 could turn into a make-or-break chapter in European banks' history, depending on their business agility.

Using sophisticated software applications and authentication techniques, retailers will be able to cut out financial intermediaries in transactions and receive payment funds directly from client bank accounts. Nimble, non-bank players will be able to offer the payment services traditionally offered by incumbent banks, but without the vast regulatory obligations that come with actually being a bank, and owning bank infrastructure. → A

A central pillar of PSD2 focuses on empowering consumers by giving them control of their financial information. Banks will be compelled by third party payment service providers (TPP) to supply them with the relevant data, subject to clients' consent, as well as offering payment initiation services, disintermediating acquirer banks and card schemes from the payments equation.

TPPs will also be able to use the information supplied by banks to set up portals that aggregate the customers' account information held by different banks, providing a 360° view on their account holdings and a better financial planning and management experience.

VALUABLE CROSS-SELLING OPPORTUNITIES

Much of the value in payments for banks is derived from cross-selling opportunities. Their current dominance over payment and account data assists them in staying close to their retail customers, to whom they are able to cross-sell a broad range of financial products. Laying down the gauntlet to banks, TPPs will use personal finance management (PFM) portals to cross-sell the financial products of partner institutions, at the same time as offering convenience and a value proposition to customers so they can more effectively manage all their finances in one place.

While PSD2 is being applauded by many non-banks and emerging banks, it also offers potential opportunities for large, incumbent European banks, who should respond to PSD2 by operating TPP services in their own right. By doing so they will be able to use the information held by other financial institutions on their existing clients, subject to the latter's consent, to build portals offering their clients enhanced PFM capabilities, with a range of additional services as they seek to differentiate themselves from other TPPs.

BETTER UNDERSTANDING OF CUSTOMERS AND MORE EFFECTIVE DIFFERENTIATION

Gaining access to such information will also help incumbent banks to better understand their clients' requirements and behavior, potentially making cross-selling activities more effective. Innovation will be key for banks to combine such portals with payment services and provide a value offering for customers that truly differentiates their proposition from rivals.

The stakes are very high – if incumbent banks fail to make the strategic changes required to thrive in a PSD2 world, they not only stand to lose control over their clients' information, but also the backbone of client relationship (personal finances management and payments), which has traditionally helped them cross-sell a diverse range of financial products.

A FREE REIN TO INNOVATE

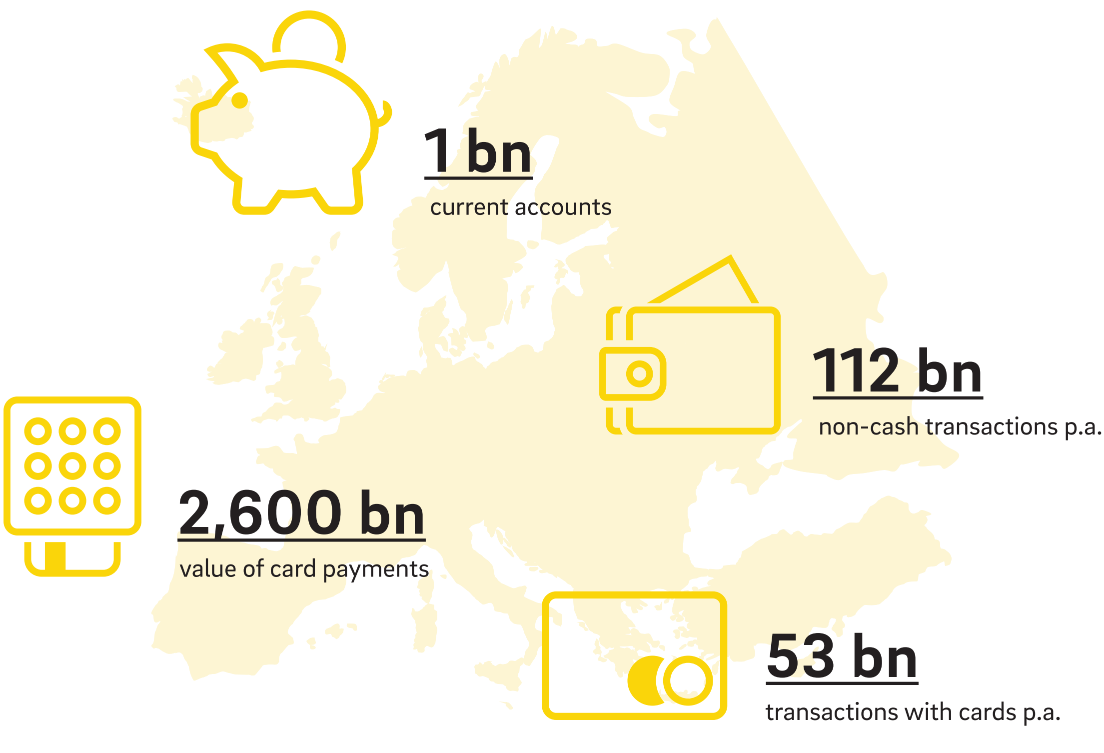
Emerging players should pretty much have a free rein to innovate, using the information incumbent banks' are compelled to share under PSD2, thereby creating more convenient ways for consumers to make payments and manage their finances. Building relationships with customers by offering a value proposition in this way could see upstart TPPs establish a substantial presence in the market.

The reality is the changes being proposed as part of PSD2 are so disruptive for the banking industry that the whole business model of retail banks is likely to be impacted. Banks need to ready themselves for the implementation of PSD2, by embracing new technology, forming new partnerships and redefining their strategy. → B

A

IMPORTANCE OF PAYMENTS

Payments are at the core of banking activities.



Source: ECB, Roland Berger

B

OVERVIEW OF PAYMENT SERVICES DIRECTIVE 2

Three major adjustments in the financial services industry mean new opportunities are to be unlocked.

1 Third party provider (TPP) regulation

→ Account Information Service Providers (AISP) – Consolidate current account information

→ Payment Initiation Service Providers (PISP) – Initiate payment order

→ Regulation enables TPPs and sets standards for them

2 Access to accounts

→ Banks to open access to account information of their clients to TPPs for free

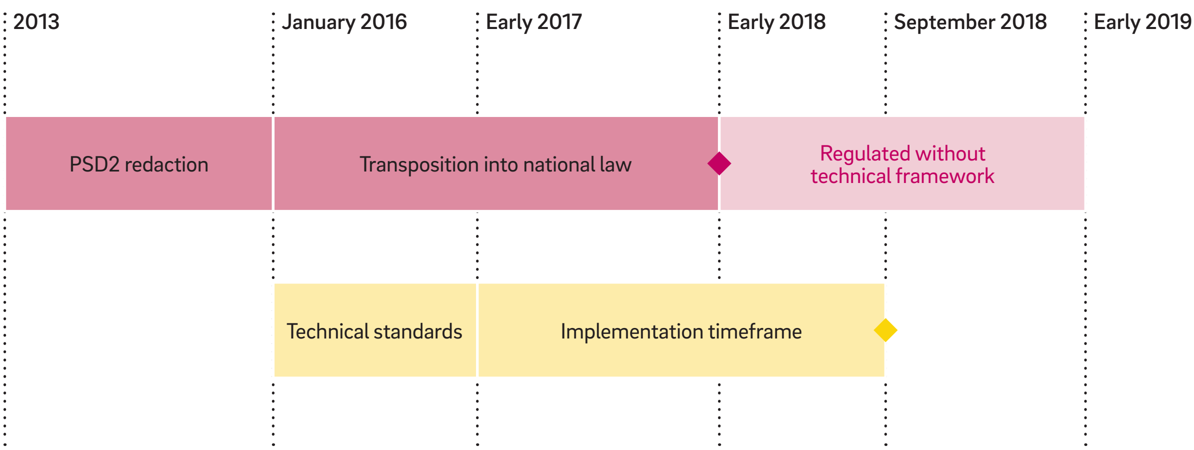
→ Access authorized through client's consent, no need for bank's consent

→ No need for contractual arrangements between TPP and banks

3 Strong authentication and secure communication

→ Stronger security requirements for the initiation/processing of electronic payments and financial data ("stronger customer authentication")

→ Strengthening of consumer rights (e.g. through reduction of liability for non-authorized payments)



Source: Roland Berger

EU regulators have long viewed banks' pseudo-monopoly as a tax on trade.

In 2009 the European Commission pushed through its first Directive on Payment Services (PSD), enshrining in law what is now known as the Single Euro Payments Area (SEPA). Under the latter, any firm should be able to send or receive cross-border payments in euros within the European Economic Area (EEA) at no greater cost than for domestic payments within their own borders.

REDUCING FEES AND SETTLEMENT TIMES

As well as lowering fees on cross-border payments to domestic levels, SEPA also cut the settlement time for such transactions from three days to one. This reduction in settlement time hit banks' profits, as it translated into a sharp fall in the amount of time payments cash is actually inside banks' systems, with a corresponding decline in the number of days over which they can receive interest on such funds.

DRIVING COSTS LOWER

Although PSD has been seen to make payment costs more uniform across the EEA and promote efficiency inside the European payments system, it is viewed as lacking the teeth to open up payments to increased competition in order to achieve the kind of aggressive cost reductions in payments fees that EU regulators envisage; the European Commission originally targeted cutting payments costs by half[1].

PSD2 is intended to address this issue by forcing incumbent banks to provide third parties access to customer account information as well as forbidding the same banks from discriminating against payments made through third parties in any way.

RADICAL IMPLICATIONS FOR CONSUMERS

The implications of this change are radical, and will touch every consumer making standard electronic purchases. Alongside the central goal of opening up the payments market to increased competition, PSD2 also aims to balance the impact of such revolutionary change by improving consumer protection and the security of payment services. The directive takes new technology into account as well as changes in consumer behavior, such as the increased use of smartphones.

CHANGES ENCOURAGE CHALLENGERS

Competition will also be increased through the simplified requirements imposed on TPPs, who will not need a banking license or to fulfill all banks' capital requirements, while at the same time requiring less initial capital.

Accounts falling under the directive are those that allow the transfer of funds to third parties and are accessible online. Under PSD2, most payment accounts will be accessible by TPPs – while savings accounts may eventually be exempt from the legislation, current accounts will definitely fall under its scope.

1 Hensmans, Johnson, Yip: Strategic Transformation: Changing while winning (2012)

Banks will face stiffer, stronger competition, so they must ensure that their future strategy is resilient.

The new directive recognizes TPPs as part of the regulatory landscape, but on a lower level to outright banks. This creates two types of TPPs for the purpose of the regulation: Account Information Services Providers (AISP), as consolidators of account information held by differing institutions, and Payment Initiation Services Providers (PISP), who initiate electronic payment transactions.

BANKS WILL BE RESPONSIBLE FOR OPENING UP ACCESS

In terms of access to payment accounts, it becomes the banks' responsibility to open up access to their systems and provide TPPs with appropriate data. With access authorized by clients and without the need for their banks' approval there is therefore no requirement for any contractual arrangement between TPPs and banks. PSD2, therefore, aims to hand ownership of account information over to the banks' clients themselves, giving them the right to determine how it is used by banks or payment providers.

COMBINING PISP AND AISP SERVICES

Essentially, there is nothing to stop non-banks from offering both PISP and AISP services – subject to obtaining the appropriate licenses. Individually, however, there are differences in the regulation of these different types of third-party services; PISPs have to apply for a payment institution license, while AISPs only have to register. At the same time, neither type of TPP is subject to own-fund requirements, instead only requiring professional indemnity insurance. By comparing the existing payments process in an online transaction with the post-PSD2 process, we can see just how transformational the directive is for the payments industry.

In today's environment, after a client enters their payment details on a website, the online retailer will eventually receive his money through various intermediaries. In a post-PSD2 world, however, the retailer would be able to request permission from the customer to use his bank details, making redundant the services of an acquiring bank or card scheme, the intermediaries that have traditionally processed credit or debit card payments on behalf of retailers. Instead, the consumer would be asked to doubly authenticate the transaction in a secure way at the point of sale, enabling the retailer to receive the payment funds directly from the customer's bank, without the need to go through an intermediary (account-to-account payment). → C

API TECHNOLOGY TO BE USED WITH HIGHER STANDARDS OF AUTHENTICATION

Access of TPPs to customer information is possible via so-called Application Programming Interfaces (APIs). In particular, PISPs will demand banks share information via APIs so that account-to-account payments can be completed – this process is balanced with the higher standards of authentication (two-factor requirements).

While SEPA saw settlement time reduced to one day, PSD2 envisions immediate settlement, using instant payments technology. This should eliminate all the remaining interest that banks currently receive when such payments funds, known as the "float", are in their system.

Payment services providers such as Apple, who have already launched similar payment services in the US, are likely to push into the European market as PISPs. Acquirer banks and card schemes, meanwhile, face an increasing risk of disintermediation as a result of PSD2.

PARTNERSHIPS ARE LIKELY

Major incumbent European retail banks are likely to launch their own PISP offerings as they attempt to maintain the client interface for electronic transactions. Partnerships in this area between incumbent banks and FinTech players appear highly likely, particularly given the prospect of intense competition in this area from some of the world's leading technology giants.

PSD2 represents an opportunity for banks to develop their own account-to-account payments solutions, including instant online/electronic payments for merchants as well as efficient refund processes for clients.

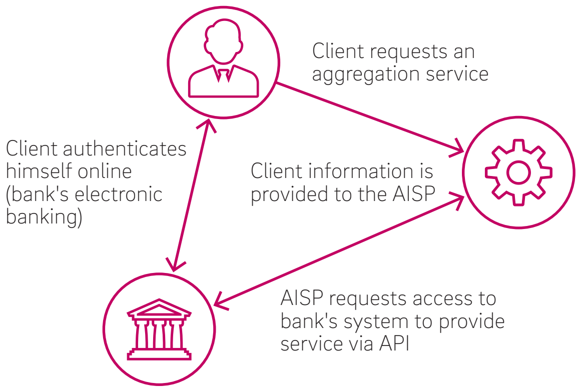
Niche players already offering API-like services include Sofort, a platform enabling fast and direct bank transfer payments. The platform incentivizes customers by offering discounts with select merchants, and charges 0.9 % + EUR 0.25 per successful transaction. PSD2 should increase customer confidence in such niche players, by regulating them and ensuring higher standards of security and authentication; it will also put their businesses on a surer footing given that the big banks will be compelled to provide information on clients' accounts, subject to customer consent, and be prohibited from discriminating against such firms in any way.

C

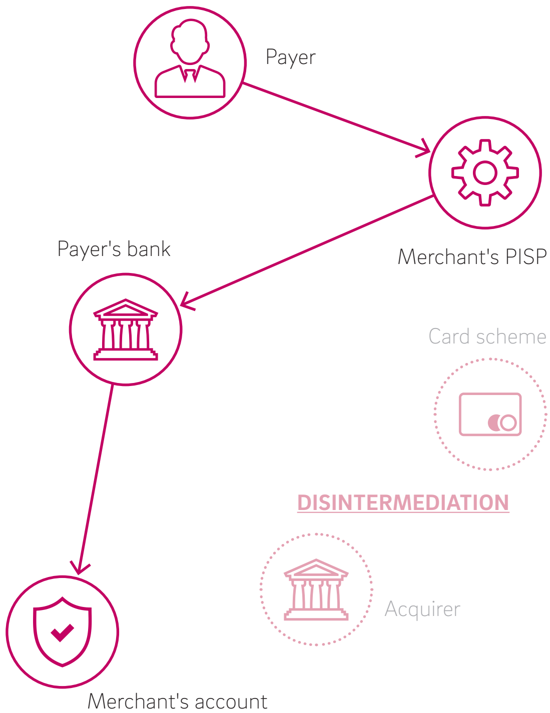
NEW MODELS AND IMPLICATIONS

AISPs will offer new platforms aggregating account information, while PISPs will allow for new account-to-account payment services. Open accounts are a key enabler for digital processes (e.g. digital credit rating) that can help banks to cut costs.

AISP



PISP

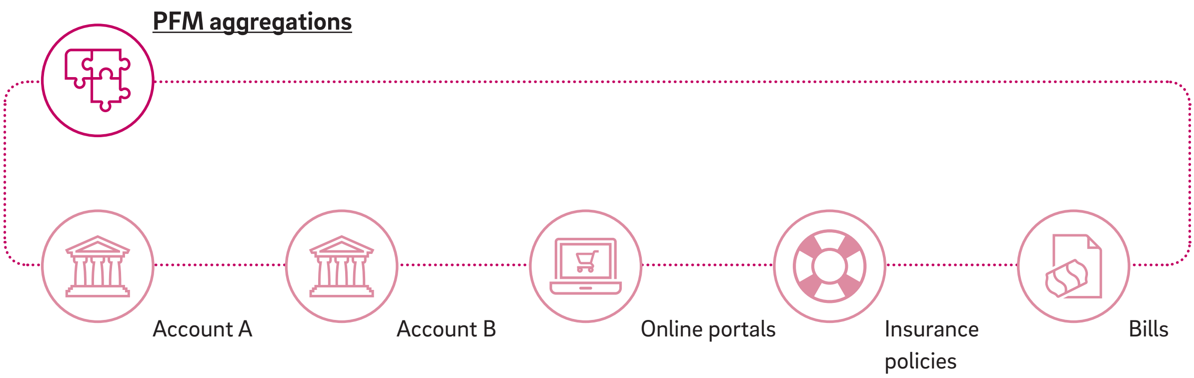


Source: Roland Berger

D

PFM AGGREGATION

PSD2 will accelerate Personal Finance Management solutions – One account consolidating all financial information on the client.

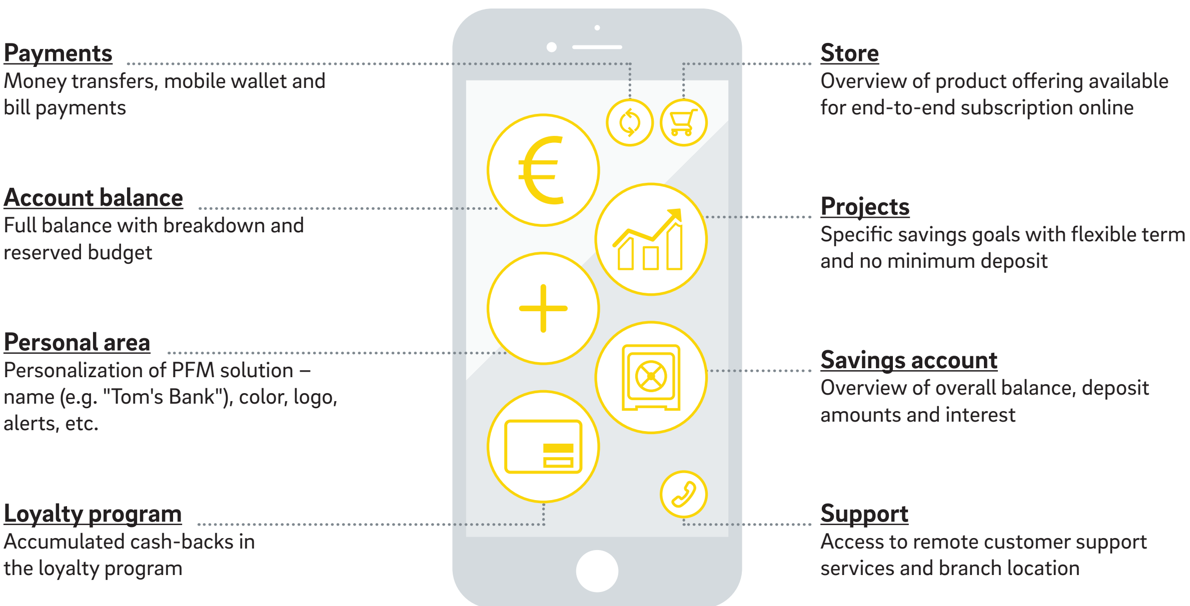


Source: Roland Berger

E

A NEW EXPERIENCE IN DAILY FINANCIAL MANAGEMENT – EXAMPLE

PSD2 will allow banks to deliver a new client experience supported for information and payments.



Source: Roland Berger

Customers will be able to access all their bank accounts through a single portal, giving them a global overview.

The changes to the payments process represent an obvious transformation that customers are likely to notice virtually overnight through the implementation of PSD2. The implications of the directive's stated aim to improve convenience for customers and widen the scope of services offered are huge. It could well prove to be the element of PSD2 that ultimately has the most far reaching consequences for the banking industry.

At present, if you have different bank accounts, held with different institutions, you normally need to log in to separate portals in order to manage your finances; this should all change with PSD2. Customers should instead be able to access all their bank accounts through a single portal, giving them a global overview of all their finances in one place. PSD2 designates Account Information Services Providers (AISPs) as the third parties that will assimilate all customers' financial information in this way, subject to obtaining all the relevant customer permissions. In short, PFM solutions have convenience on their side.

USING PFM TO INCREASE CUSTOMER ENGAGEMENT AND SUPPORT CROSS-SELLING

European banks could use PFM solutions themselves as a means of increasing customer engagement and supporting product cross-selling. For incumbent banks, forging partnerships with FinTech firms already active in this area is likely to foster implementation of PFM solutions far more effectively, quickly and efficiently than if they should choose to develop their own PFM tools in isolation.

Of course, the model effectiveness will still very much depend on the information customers decide to give AISPs. However, such an arrangement is likely to gain increasing traction with customers, as they will save time by only having to log in once and will no longer have to go to the trouble of remembering or storing numerous passwords and PIN numbers. PSD2's drive to specifically regulate such providers, as well as demand higher levels of authentication and security, should also greatly enhance customers' confidence in the model.

AISP CONSEQUENCES MAY WORRY BANKS MORE THAN THE PISP IMPLICATIONS

The potential consequences of AISPs are in some ways more worrying for banks than the payment initiation services offered through PISPs. If customers are no longer logging onto their websites, there is intuitively a real danger that individual banks' brand and services will become increasingly irrelevant, even with their long-standing customers. It follows that a customer is likely to identify with their bank less and less if they have diminishing direct contact with them, choosing to manage their finances through alternative AISPs.

For this reason, the incumbent banks are likely to increasingly want to operate such portals themselves, aggregating their existing client information with that held by rival institutions, potentially enabling them to offer an enhanced financial management experience through a more complete view of their clients' finances. → D

PSD2 BRINGS HUGE OPPORTUNITIES AND CHALLENGES FOR INCUMBENT BANKS

As well as a monumental challenge, PSD2 could in fact represent a huge opportunity for incumbent banks. The new information they can gain from third parties on their customers could support more contextualized marketing offers and improve internal processes. For instance, it should enable banks to operate machine learning algorithms, which will increase the effectiveness of their marketing campaigns at the same time as improving customer risk profiling thanks to an accurate and up-to-date view of their customers' entire financial position.

Of course, PSD2 means there is likely to be substantial growth in the number of non-bank third-party providers operating AISPs, cross-selling the underlying products of banks and financial providers. The challenge for banks will be to differentiate their own TPP offerings. At the same time they may also want to offer their products through other TPP portals. This will aid them in branding their services in an alternative way, with offers that vary from those available in their own portal. While banks may want to ensure their products are represented in some way through what emerge as other big leading portals in the market, in order to protect and grow their market share, incumbent banks should attempt to make the offerings on their own portals as exclusive as possible. → E

The requirement for strong authentication and secure communication mean that TPPs will have to obtain two-factor authentication from customers.

While there are exemptions for low-amount, recurrent or low-risk transactions, the existing online payment authentication threshold where customers just input a credit or debit card number along with the CV2 number found on the back of the card will be deemed wholly insufficient in the majority of cases.

Some large banks have already voluntarily incorporated two-factor authentication into their system, typically through the use of tokens, which are essentially small devices that generate codes to be used in conjunction with customers' PIN numbers.

An alternative to the use of tokens in conjunction with customer PINs is the use of biometrics, authentication processes that validate the identity of a user through intrinsic personal characteristics such as finger prints or retinal scans. Biometrics could gain increasing traction, particularly as customers may find it more cumbersome to have a token device in their possession every time they want to make an electronic purchase.

Enabling purchases to be transacted in a more direct way, without the services of intermediaries, while providing third parties with customer information, naturally brings the question of security to the fore. At the same time, having all customers' data from multiple bank accounts stored in one portal arguably concentrates the security risk.

PSD2 will introduce three opportunity areas for both emerging players and incumbent market participants.

DELIVERING A NEW EXPERIENCE IN DAY-TO-DAY FINANCIAL MANAGEMENT

Banks should integrate AISP and PISP capabilities as a holistic solution, integrating payment initiation services actions within their PFM portals.

As well as being an area where customers can manage all their accounts, and browse information about other products offered by their bank, the PFM could become their platform for day-to-day transactions, including both payment and transfer solutions.

VYING FOR CUSTOMER LOYALTY

Banks should attempt to position such a holistic platform solution as their customers' preferred choice for online shopping, while also offering an integrated wallet solution for offline shopping. Such a holistic approach could build customer loyalty by encouraging daily banking usage, as well as providing the information, advice and action that customers require for their ongoing, everyday financial needs.

CROSS-SELLING ACROSS FINANCIAL SERVICES AND BEYOND

Such an integrated platform should support the cross-selling of bank products; however, there is no reason why banks should limit the scope of such cross-selling opportunities to financial services alone, particularly given the more direct relationship that they will have with retail merchants owing to the tendency of PSD2 to eliminate intermediaries. Banks should also develop their platforms with as much flex-

To thrive, banks will have to maintain an interface with their clients in a world where competitors will be able to readily use the information they hold to launch rival platform solutions.

ibility as possible, with scalability to handle future growth and the flexibility to make modifications over time. There is a lot at stake: in our estimation no less than 25-40% of the net banking income (NBI).

Banks' new value proposition should aim to combine both AISP and PISP capabilities in one platform, focusing on delivering a high-quality value proposition that differentiates from those of rivals and cultivates customer loyalty.

Faced with the prospect of intense competition, banks should focus on developing innovative solutions that cultivate customer loyalty and the continued use of their platform. For example, they could offer exclusive discounts on partners' products and services, both financial and non-financial, allowing customers to earn points through portal usage.

To enhance consumers' experience, banks should consider building open systems so that offers from both financial and non-financial partners are available through their platform in a dynamic and relevant way.

PSD2 makes it imperative for banks to use technology to drive their business strategy, rather than treating it as merely a support function. Banks should focus on enhancing the PFM experience of their customers by aiming to continually improve the functionality of their platform.

At the same time, the retail banking landscape appears on course to change so dramatically that banks need to keep an eye on the bigger picture if they are to grow or maintain market share over the longer term. One should not forget there are already examples of live use in the market, as well as more that are planned to be introduced very soon. There are also a growing number of new players already anticipating the PSD2 changes and impact - even before it officially comes into effect.

In simplistic terms, banks could face a choice over whether to focus on adapting and integrating more service layers as they seek to refine their own platform proposition, or aim to improve efficiency and become effective product factories so that others can take responsibility for the client management side of the equation.

Certain banks may well find that the optimum balance lies somewhere between profitability and volume; operating a dual strategy where they offer their own branded products through their own portals, while allowing alternative service providers to simultaneously market their products under different brands and on varying terms through TPP platforms. ◆

MAKING A SUCCESS OUT OF PSD2 REGULATION

Deliver personal finance management experience into clients' pockets

Ensure fast, secure, simple and personalized client experience

Build an open ecosystem and deliver additional service layers via partnerships, e.g. non-FS products

Leverage loyalty programs to incentivize action and enrich client experience

ABOUT US

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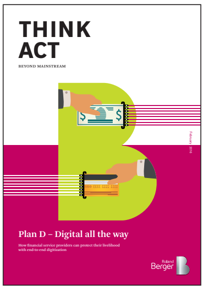
FURTHER READING



PLAN D – DIGITAL ALL THE WAY
How financial service providers can protect their livelihood with end-to-end digitization

The recipe for success is digitization from start to finish. And finance is one of the industries with the greatest potential for all things digital. Why? Because data – client and transaction data, to be precise – is the raw material that every bank and insurer gathers, sorts, processes and links together. In principle, almost every aspect of their business could be digitized in its entirety. Which makes one wonder why many incumbent financial service providers are still essentially analog operations.

FINTECHS IN EUROPE – CHALLENGER AND PARTNER

86 percent of Europe's FinTechs put their money on collaboration with established financial service providers. FinTechs perceive customer confidence as the key to success and as one of the strengths offered by incumbents. Young companies see the best chances in asset management, payments and crowdfunding. The UK, Ireland and France are the hottest markets for start-ups – Germany has some catching up to do.

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