PSD2 opens the door to new market entrants

Agility will be key to keeping market position

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The newly agreed Payment Services Directive 2 (PSD2) paves the way for significant changes to the payments market. This regulation needs to be carefully considered given its far-reaching impacts on how the market operates and not be treated as a straightforward compliance exercise. As at the end of October 2015, the regulation has been voted on and approved by the European Parliament and will shortly be formally adopted and published. Once this happens, EU Member States will have two years to implement the changes which can therefore be expected to come into force by the end of 2017.

Introduction

Following the vote to adopt the new Directive, the European Commission highlighted key parts of the new legislation in its press release: making payments throughout Europe safer and more secure, and enabling innovation by allowing new payment services to enter the market.

The drivers behind the regulation are clear: innovation, competition, and consumer protection. These are recurring themes that are being consistently pushed by regulatory authorities throughout Europe, both centrally and within its Member States.

The changes proposed by the PSD2 regulation are far-reaching. Set against a backdrop of increasing Fintech investment, PSD2 now enables many new third parties to participate in a market that has previously not been open to them. Existing players in the payments market must be responsive to the new challenges that this brings.

Overview

The original Payment Services Directive (PSD) was released in 2009 and put in place a legal framework for the Single Euro Payments Area (SEPA) for payments made throughout Europe. The aim of the PSD was to increase competition through new market entrants, improve payment efficiency, and reduce costs. The revised PSD2 has recently been agreed as a means to respond to changes in the payments landscape occurring since the original PSD was enacted.

PSD2 extends the original scope of the PSD and in particular increases the number of new entrants into the payments market, which in turn affects competition and increases the variety of payment services available.

PSD2 includes many new areas that bring into scope a number of new payment operators from gift card/loyalty schemes to account access services and mobile wallets.

The new regulation builds upon a number of areas within the original PSD, extending and clarifying some of the original articles and driving a higher focus on payments innovation, particularly in mobile. New areas of the directive include opening access to customer accounts and payment processing services.

Alongside PSD2, a second regulatory initiative (Regulation (EU) 2015/751) introduces a cap on interchange fees for card-based payments. Interchange fees are fees that are set by payment card schemes and are paid by the merchant's bank (acquiring bank) to the customer's bank, which issued their card (issuing bank). These payments are generally not visible to either merchants or consumers.

The focus of the Interchange Fee Regulation (IFR) is to remove *"direct and indirect obstacles to the proper functioning and completion of an integrated market for electronic payments, with no distinction between national and cross-border payments"*[1]. It will have significant impact on many players in the existing cards market and is forcing banks and card schemes to reconsider elements of their operating models.

Key Changes

With a range of new banks and payment companies emerging, consumers are being provided with ever higher levels of convenience with respect to payment services. As these new companies access the payment systems and accounts of the more established financial institutions, responsibilities for key areas such as security, refunds for unauthorized payments and correct payment execution are becoming spread across the different players. This is leading to a lack of consistency in consumer offerings. This issue is addressed in PSD2, which brings these new organizations fully into scope.

1 *Source: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2015:123:FULL&from=EN*

Some of the key changes enforced by PSD2 are described below:

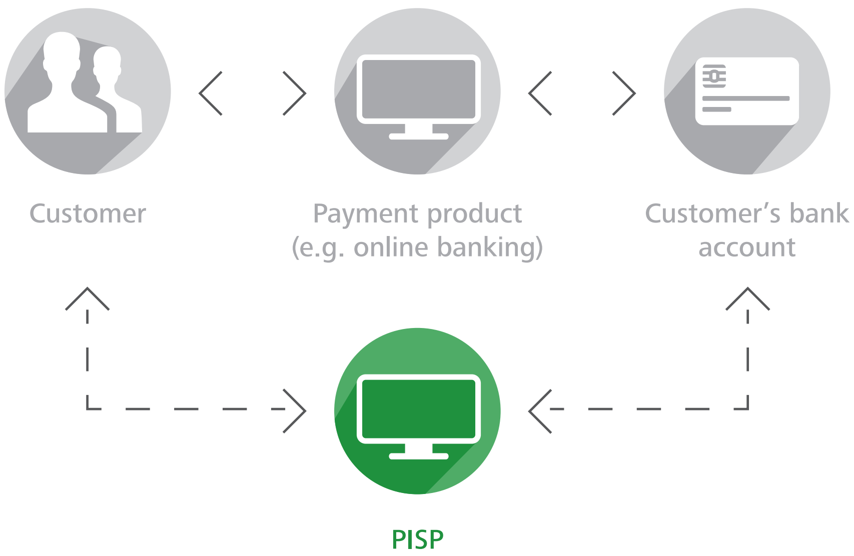
1. Usage of Third Party Providers
Currently, the only way for customers to access their bank accounts to make payments is through products and channels provided by their bank, as shown below:

Current approach

New areas of the directive include opening access to customer accounts and payment processing services

Under PSD2, two new types of Third Party Providers (TPPs) will emerge:

1. Payment Initiation Service Providers:
PSD2 will encourage competition in European payments by regulating Payment Initiation Service Providers (PISPs). Rather than the payer initiating the payment directly with their bank, the payer initiates the payment via the PISP, which in turn passes the instruction to the bank.



2. Account Information Service Providers:
These providers act as aggregators of customer payment account information. For example, presenting the Payment Service User (PSU) with an aggregated viewpoint of transactions and balances from more than one account. Currently, a PSU with more than one account would have to access each individually through a separate interface. Under PSD2, Account Information Service Providers (AISPs) are able to consolidate information from multiple accounts and present this back to the PSU.

AISP example

Of particular note, PISPs and AISPs will not be able to enhance their business model by using data captured during payment transaction processing, as the legislation forbids them to use this data for any other purpose than the provision of the payment service.

In addition, PSD2 defines traditional financial institutions that hold deposit accounts as **Account Servicing Payment Service Providers (ASPSP)**. In terms of pricing, PSD2 makes it clear that ASPSPs may not charge differently for payments initiated through the PISPs than they would for payments initiated by the PSU through their own systems.

The usage of TPPs provides consumers with additional options to access their bank, removing the need to interact with the bank directly. To enable TPPs to connect directly to a customer's bank, new technical standards are being developed by the European Banking Authority (EBA), which will define the connection requirements and API to be used. This is referred to as "Access to Account" or XS2A.

The usage of TPPs is the most significant change proposed by PSD2 as it alters the way payments can be made by a consumer. This in turn is expected to foster innovation and encourage new entrants to enter the payments market.

2. Security and Authentication Requirements

Security is a key component of PSD2 and the regulation introduces new security requirements covering account access and electronic payments. It also requires significant security requirements to be implemented by AISPs and PISPs. The security requirements build on the guidance already issued by the EBA in its Guidelines for the Security of Internet Payments[2].

The most significant requirement is for payment transactions to be subject to strong customer authentication. The EBA is responsible for the preparation of draft technical standards, which will define how security measures are implemented in practice under PSD2.

All Payment Service Providers (PSPs) including TPPs will need to ensure they can demonstrate adherence to the new security requirements. There is also a requirement for PSPs to provide to the competent authority a comprehensive assessment of the operational and security risks relating to their payment services on an annual basis.

3. Extension of scope

PSD2 includes in its scope "one leg out" transactions which are payments made to or from locations outside Europe. Whilst only the European parts of these transactions are caught, PSD2 aims to provide transparency over end-to-end charges and delivery terms.

Transactions that are made in non-European currencies will be captured under PSD2 where the PSPs for the payer and recipient are located in the European Union (EU). Transactions in any currency where one PSP is located in the EU and one PSP is located outside of the EU, will also be included within scope as "one leg out" transactions. These transactions were out of scope of the original PSD; the new regulation will therefore bring a large number of additional transactions within its remit.

PSPs will need to carry out an impact analysis and assess which parts of each transaction qualify as having been "carried out in the Union" and ensure adherence to the regulation for these segments.

Changes under the IFR

In December 2015, the IFR brings in caps on interchange fees of 0.2 percent and 0.3 percent of transaction value for debit cards and credit cards respectively. EU Member States will be able to enforce lower caps than those required by the legislation. Three party payment schemes that use PSPs as issuers or acquirers are covered by the regulation and will be allowed a transition period of three years as long as they do not exceed more than 3 percent of the market value of total card transactions on an annual basis. The compliance date for these three party schemes is expected to be December 2018 while other three party schemes are excluded from the regulation.

2 https://www.eba.europa.eu/regulation-and-policy/consumer-protection-and-financial-innovation/guidelines-on-the-security-of-internet-payments

The other major change enforced by IFR is that from June 2016, payment schemes and processors are required to be separated in terms of their accounting, organization and decision-making process. This significantly changes the operations of the schemes.

Impacts of PSD2

There are far-reaching impacts from the new regulation on all payment providers. In particular, there is an onus on the banks to ensure they adhere to the new requirements for access by third parties and for increased online and mobile security. They will have to deal with a number of new intermediaries as an additional layer between them and their customers. Whilst financial institutions will need to ensure they achieve compliance with new access and security requirements, the changes under PSD2 will also have a wider impact, encroaching upon payment revenue and introducing numerous competitors into the market. This must be carefully considered and will result in changes to commercial relationships and existing business models.

The impacts on specific parties are discussed below:

PISPs and AISPs

These newly defined TPPs under PSD2 will need to ensure they have structures in place to demonstrate appropriate compliance with the requirements of the regulation. For newer or start-up providers, this may entail significant changes to existing operating models. Other areas of consideration are listed below:

- Demonstrating compliance with the necessary security requirements for submitting payments is key area for TPPs. These requirements are likely to be extensive and will include obligations from both a customer authentication perspective as well as security over communications with ASPSPs
- The ability to prove that payment transactions have been executed appropriately and in line with regulatory requirements is key in the event of any disputes in respect of non-executed, defective or late payment execution

The usage of Third Party Providers provides consumers with additional options to access their bank, removing the need to interact with the bank directly

- From a data privacy perspective, TPPs must ensure that data collected is protected and be able to demonstrate it cannot be used for any purpose other than the provision of the payment service
- As with any new payment service, this is likely to be subject to an increased level of interest from fraudsters. New providers should be wary of this threat and ensure that they are able to comply with the stringent requirements on refunds in the event of unauthorized transactions occurring
- Resilience is another key area of relevance to new TPPs as PSD2 enforces strict rules on non-execution, defective, or late execution of payments

Banks

Banks need to consider their response from both a compliance and competition perspective, in terms of how they react to TPPs. The latter will require significant research and strategic planning. Of note, the regulation does not preclude banks from acting as TPPs and so banks may want to consider whether and how they wish to offer similar services to newer Fintech entrants.

Some of the other areas banks need to consider are listed below:

- Banks will need to adapt their current compliance mechanisms for PSD to build in any new requirements from the updated regulation. Risk and compliance impacts on products and operational functions will also need to be considered
- In the same way as for TPPs, one concern is around security risks and protection of sensitive customer data given interactions with TPPs. Whilst standards for access are still being drafted, clear attention needs to be paid to how these standards will work and what level of security protection will be provided

Banks needs to consider their response from both a compliance and competition perspective, in terms of how they react to TPPs

- Additionally, from a security perspective, banks will need to ensure compliance with security requirements, including two-factor authentication for payment transactions and access to sensitive payment data. Whilst regulatory authorities in the majority of EU Member States have confirmed they will require banks to comply with the EBA Guidelines for the Security of Internet Payments, some Member States, including the United Kingdom, do not currently require this. For those that do not, a higher level of changes will be required by any banks that are not in compliance with these EBA Guidelines
- Also, of note for all Member States, the current EBA Guidelines only cover Internet payments. Other payment channels such as mobile will also need to be considered
- Resilience of payments is a recurring issue for many banks and further consideration should be applied to this area from the perspective of PISP and AISP connections to initiate payment
- Prioritization of payment requests from TPPs is also important. PSD2 is clear that these payments must not be treated with any form of discrimination compared with payments initiated directly by a bank. Banks must ensure they can demonstrate that appropriate and fair processing capacity is provided for these payment types.
- An impact analysis of "one leg out" transactions will also be required to ensure that the segments of these transactions performed in the EU are subject to PSD2
- Assessment and investigation of the inherent fraud risk from the opening up of access to PISP and AISP services

APIs

The EBA will release technical standards that will cover the interfaces between TPPs and ASPSPs. The level of detail of the interfaces' specifications is as yet unknown. The EBA will, however, be required to consider:

- Strong authentication requirements and any exemptions based on the level of risk of payment services, recurrence of payment transactions and payment channels used
- Safety of PSU funds and personal data.
- Fair competition among PSPs and technology and business model neutrality
- Allowing the development of user-friendly and innovative means of payment
- Risk to specific devices and different transaction types, such as contactless
- Reviewing and updating the standards on a regular basis

- IT development will be required to provide TPPs with access to consumer accounts, and to differentiate between when an AISP accesses information and when the PSU accesses information

ASPSPs will be required to:

- Ensure they communicate securely with PISPs.
- Make all required information immediately available to a PISP after receipt of a payment order.
- Treat payment orders from PISPs without any form of discrimination.

ASPSPs may deny PISPs and AISPs access to payment accounts for objectively justified and evidenced reasons related to unauthorized or fraudulent access to the account by the PISP or AISP. In these cases, the ASPSP must immediately report the incident to the competent authority and also notify the payer before access is denied, if this is possible, or at the latest immediately after.

IFR impacts

As well as the card schemes that will need to separate their processing capability, card issuers in particular are likely to be significantly affected by the reduction in interchange fees and will need to consider how existing business models and pricing strategies will adapt to the regulation.

Cross-border acquiring could also be impacted if some EU Member States set lower levels of interchange fee than the imposed caps. This may disadvantage overseas acquirers if domestic rates in a particular country are lower.

Conclusion

The amount of change that is coming through PSD2 is very significant and clearly has the ability to alter the payments market in a number of ways for the consumer and current market participants. There are major underlying impacts for existing market players from a strategy and competition perspective, as well as a higher compliance burden that will be enforced on all new and existing payment players.

New providers face an exciting challenge, as they are able to enter the market without access restrictions but should not underestimate the requirements of the regulation and the burden in being able to actively demonstrate compliance.
For well-established market participants, the ability to be agile in response to PSD2 and adapt services to counteract increased competition is key to ensuring market position is maintained.