PSD2 OPENS UP A WORLD OF OPPORTUNITIES BUT WHO WILL BENEFIT FROM THEM?

Since 2004, the EU has been working towards the standardization of nationally denominated direct debit (DD) and credit transfers (CT).[1] The Single Euro Payments Area (SEPA) project became regulation in 2012,[2] and a number of SEPA EU schemes were rolled out. By 2016, the schemes were also adopted by the UK and the rest of the non-EURO SEPA countries.[3] To date, the project has cost approximately £10 billion,[4] with a large proportion due to the direct cost of migration to ISO 20022 (a regulatory requirement). During this period, across the EU, a number of domestic real-time payment schemes have also emerged, such as Faster Payments in the UK-operated by Vocalink and owned by Mastercard.[5]

In January 2018, PSD2 legislation came into effect to address multiple objectives: to enhance security, to stimulate competition in banking and together with the SEPA regulation, to unify the payments industry across the EU.[6] PSD2 also echoes the global governmental initiatives of cashless societies. The UK in general has been leading the process of opening up the industry to non-banks with Open Banking (OB), the mandate by Competition and Markets Authority (CMA) to the nine high street banks to open up their application programming interfaces (APIs) to third party providers (TPPs).

PSD2 introduced technical standards that need to be satisfied across the EU to ensure the security of all types of payments, and of data exchange between banks and TPPs. It holds the European Banking Authority (EBA) responsible for setting the acceptable fraud rates and for supervision of the industry. Multiple revisions of the implementation guidelines (Strong Customer Authentication (SCA), API standards and secure exchange of information) have been necessary to satisfy its conflicting objectives and those of a wide range of industry participants. PSD2 introduced two types of regulated TPPs that could innovate by accessing core banking technology through open APIs; account information service providers (AISP) and payment initiation service providers (PISP).

After an expenditure of approximately £1.5 billion pounds by the nine major banks over three years,[7] the industry is far from ready, both in terms of SCA implementation, and developer portals that offer usable APIs. Only a few major banks offer payment services based on PSD2. Out of the incumbent banks that do offer pay-by-bank options, in response to PSD2, card schemes are acting as their enabling partners. This way strategic partnerships between card schemes (and established PSP) and incumbent banks are re-enforced and the relevance of both entities is guaranteed.

As for the majority of challenger banks, their enabling partners are either incumbent banks acting as agencies or investors and/or established PSPs. Challenger banks are essentially fintechs that came to the realization that acting as AISP/PISP without being a bank could not guarantee customer trust, control over the customer experience or the ability to exploit core banking business models (financial product offering). Therefore, they opted to obtain bank charters or at the very least e-money institution licenses (EML). Having either ensures ability to also act as PISP/AISP.

However, many are still struggling to fully convert and maintain customers, or to convert their EMI licenses into full banking licenses that would allow them to become truly competitive. These market signs raise concerns regarding what was PSD2 set out to achieve, what it has achieved and how will it enable competition and ultimately cost reduction or other benefits for merchants and consumers.

The notion of OB and one of PSD2 objectives, is to convert core banking into platforms suitable for add-on services that can be plugged in through the use of APIs developed by banks and fintechs. These are supposed to be freely available to any authorized TPP. The concept of open APIs is far from new in the software industry. They enable developers to tap into exposed data or functionality, in most cases for free (at least initially), and create new offerings.

Companies like Google and Facebook evolved into thriving developer communities by owning and leading successful API business models since 2005. Their strategies focused on gaining popularity in the developer communities through marketplaces featuring extensive support for free (at first) and communication which fed back to improvements in their APIs.

1. https://www.europeanpaymentscouncil.eu/news-insights/insight/sepa-direct-debit-green-light
2. https://ec.europa.eu/info/business-economy-euro/banking-and-finance/consumer-finance-and-payments/payment-services/single-euro-payments-area-sepa_en
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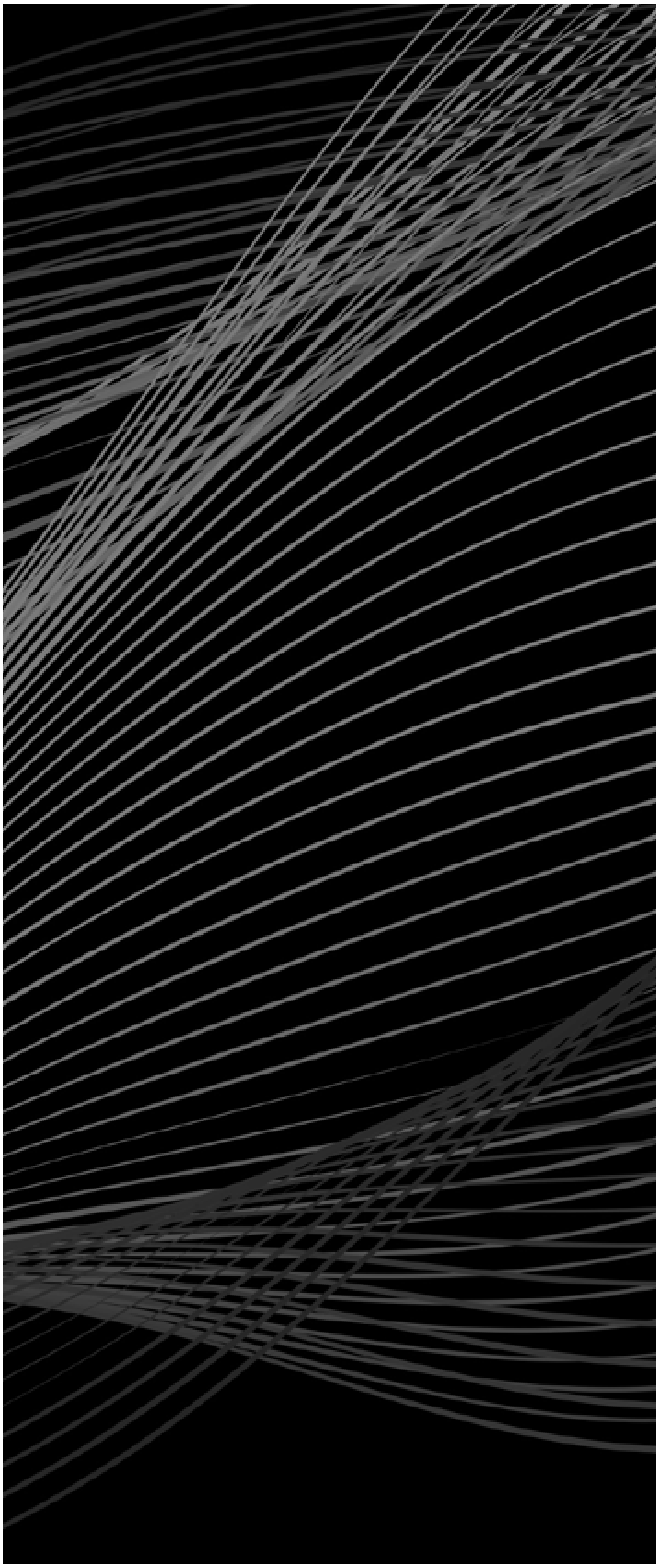


However, unlike bigtechs (e.g. Apple, Facebook, Google, Amazon), challenger banks, PSPs such as Stripe or Paypal, incumbent banks are not software companies, nor do they have the incentive to move in this direction. This is due to the stable revenue streams which incumbent banks have established from core financial products and merchant services. For incumbent banks to lead a successful and profitable PSD2 monetization model, it would imply a drastic transformation to act as technology companies.

However, success in this approach would require banks to maintain and update APIs, and to create a flourishing developer community. Monetization can be achieved via a two-tier API model, a free 'basic' tier, and a 'premium' tier that provides revenue streams. A tiered business model is something that even Google struggled to maintain[8], leading to the more common 'pay as you go' API business model.

So far banks have adopted the reactive approach of remaining compliant with the help of their existing partners (payment providers), while at the same time investing in fintechs that can do what they cannot, i.e. build the free services that would hook customers and help with gaining insights. Those insights can in turn enable rapid innovation on financial products, the banks' key revenue stream.

At the same time, consumers are increasingly getting used to services and user experiences provided by bigtechs and major retailers. Customers' expectations keep rising. This implies that if banks cannot maintain the same standards, or if they don't have the option of becoming a cheaper alternative because they are relying on services of intermediaries, a gap will exist in the market for somebody else to cover. It is natural to wonder whether bigtechs will step in to bring true disruption, like in Asia (e.g. Tencent). Bigtechs are already setting the standards and expectations in terms of customer experience and some (e.g. Google, Amazon, Facebook) have opted for the same type of license (EMI licenses) on which the majority of challenger banks operate.

If a bigtech was to move to the banking space (e.g. Apple offering credit cards issued by Goldman Sachs), it would enable truly competitive services. Bigtechs are in a great position; in control of critical infrastructures, with capital that allows them to make investments or offset the cost of offering necessary free services. They additionally benefit from a rich dataset on their customers, customer trust, and are the ones setting customer expectations in shopping and payment experiences just to mention a few domains.

8. https://geoawesomeness.com/developers-up-in-arms-over-google-maps-api-insane-price-hike/

A bigtech could significantly reduce costs by eliminating all intermediaries involved in offering an end-to-end service. This would make any paid services or (financial) products offered truly price competitive in a way that nobody else could achieve. This, and the convenience of a one-stop shop, would be great ways to incentivize customers to switch.

Without this happening, in the current ecosystem, banks can fully benefit from PSD2. By staying focused on their existing business model based on financial products incumbent banks can, through investments in fintechs, attract more customers or better profit from existing ones.

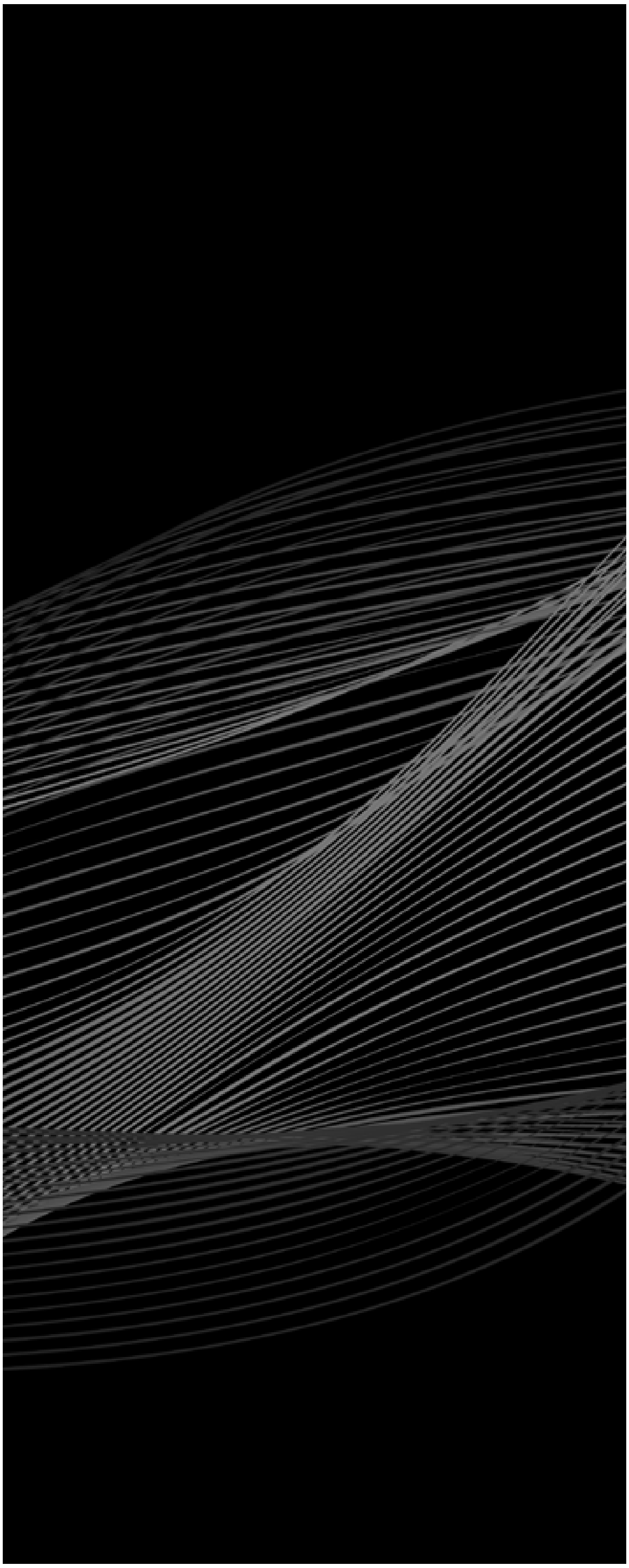
As long as challenger banks cannot operate autonomously (i.e. have direct access to clearing and settlement infrastructure and accept deposits) and/or gain trust, they will not be able to fully benefit from PSD2. In the best case their revenues will be coming from traditional banks that will be paying them to develop the free services needed to hook customers.

A competitive fintech may be able to generate additional benefits from direct monetization of their APIs but it will be hard to compete with bigtechs that are already the major providers of key infrastructure and with established customer base.

This discussion would be incomplete if we forget to mention the consumers and merchants who are meant to be the beneficiaries of all the transformations/innovation. The most obvious benefit at the moment is a plethora of free services that help them better understand their finances and lifestyle and manage those. Of course, this is also advancing the insights that FIs (or fintechs and bigtechs) can use to refine their revenue streams. Depending on the extent to which consumers and merchants wish to share data in return for these free services, they can receive a greater variety of tailored (paid for) products.

In the current ecosystem, although there may be a wider range of financial products to choose from, it is unlikely that merchants and consumers will experience significant cost reductions. This is because PSD2 will not have achieved its goal to break existing monopolies. On the other hand, in the scenario where a bigtech steps into the banking space, the monopoly is simply replaced by another one.

While this different kind of monopoly is being established, the consumers and merchants will benefit from cost reductions. This is because there will be a fight for winning customers over. This reality though may be only temporary and can easily be removed when there is nobody to compete against.



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